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Free Trade Means Destabilisation

by Wolfgang Hager, Florence*

There seems to exist widespread agreement on the superiority of free trade over other forms of trading systems with protectionism being accepted, at best, as a temporary device for slowing down adjustment processes. As against that, Dr. Hager argues that the markets of industrialised and developing countries can only destabilise each other when linked by an international megamarket. He therefore advocates an alternative trading order involving managed trade.

The current, near universal consensus about protectionism can be summed up as follows: There is a clear interest in free trade, a policy which promotes international harmony while making almost everybody better off. Exceptions are made to accommodate powerful special interests at the public's expense. Or compassion may dictate a slowing down of the adjustment process. But since market forces cannot be bucked, protection should always be a temporary device, to be abolished as soon as the industry has adjusted. Even politicians who support protectionism do so from political expediency and, one suspects, against their better judgment.

Others favour protectionism without quite realising it: those who argue for state policies designed to gain a head start on others in the race for high-technology: shutting others out of markets yet to be created. This version of mercantilism is favoured by international institutions, since it implies adjustment in the North-South context, forgetting the trade problems caused by this form of mercantilist market distortion among the advanced countries. Its proponents are, moreover, dreaming of an economy for supermen, in which that half of the advanced countries' population which has an I.Q. of a hundred and below risks being marginalised.

The promise of the new age is truly staggering. Some of the worst aspects of industrialisation can now be solved, not by the remedial policies of a European-type welfare state, but by leaving repetitive and dangerous assembly-type work to automated production. At a cost, pollution can be sharply reduced by technology now available. The waste of raw materials and energy can be curtailed by smarter production methods and products. Total national wealth can grow substantially.

The very big "if" of this scenario is the profound economic and social disequilibria it could cause, serious enough to delay its implementation and nullify its promise. One hundred years ago, from 1873-1895, the world went through a prolonged recession. Technological breakthroughs in steel, chemicals, transport, etc. brought immense productivity gains. Yet growth remained sluggish, unemployment rose, and real incomes of workers actually declined. Europe tried to solve the overproduction crises, and the related domestic social tensions, by imperialism, and then by a tragic arms race. Only slowly, after much painful experimentation, did Europe hit on the means of combining high growth with equilibrium: high wages, sharply reduced working hours, ample insurance for victims, humane if costly health and pollution regulations, investments as much for social as for "productive" infra-structure, and a mix of macro- and micro-level interventions to maintain equilibrium in regional and national labour markets.

The result was not only very rapid economic growth, but, for all its wants, the most decent society ever created in history, with a pleasant urban and natural environment and, the greatest miracle of all, the absence of a police state. America has only partially followed Europe on this path, with the sirens in the ghetto a reminder of unfinished business.

Disappearance of the Atlantic Monopoly

A precondition for this achievement was the relative freedom of society to work out, by private bargaining and public legislation, the cost and conditions of doing business. This autonomy rested on the monopoly, enjoyed by the Atlantic nations, over modern forms of production. It began to erode little over a decade ago, bringing into intensive interaction not only different markets, but more importantly, different socio-economic

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systems. Below, it is shown why, in purely economic terms, market adjustment among these different systems can only produce severe imbalances at home and abroad.

Even the attempt to do so implies a radical adjustment, towards "best international practice", in the way we do business with each other: an introduction of the 19th century into the late twentieth. Without quite realising the enormity of what they are saying, free traders and governments demand that real wages be cut in line with international standards; night shifts for women be re-introduced in the textile industry; health and environmental regulations be eased to assure competitiveness; investment be channelled into the production of tradeables. Some enthusiasts in Europe and America even argue that free enterprise needs a heavy dose of state-guided capitalism, for that, too, is best international practice.

Until the late sixties, trade in manufactures was largely an Atlantic affair. Eastern Europe produced low-standard goods which could not be sold to the West at any price. Japan was limited to one or two product lines destined for one regional market in the US. The Third World seemed permanently unable to break the trap of poor human and physical infra-structure, small markets, lack of investment capital and know-how to play more than a marginal part in the industrial division of labour.

This monopoly has disappeared. Apart from a lowering of transport costs and better communications, the single most potent agent of change was the multinational corporation which turned a potential world market into a reality. It transferred technology, know-how, access to world markets and finance in a package which unlocked the underutilised productive capacities of new-comers. By the early 80s these had captured 20 % of world export markets in manufactures.

Japan diversified its markets and products. Eastern European countries became major suppliers of manufactures to Western Europe. The newly industrialising countries (NICs), a dozen quasi-NICs, and the export zones of an additional twenty or so countries began to supply the markets of the old industrial countries. In conventional terms, this is a stunning success story, although some development economists warn of the distortion of production and consumption inherent in such growth strategies, no less damaging than the earlier integration of the Third World into world markets for agricultural commodities. From the point of view of the old industrial countries the problem is a different one. The key point is the Walrasian law which states that the creation of a single world market for capital, and a single market for goods, automatically creates a single world market for labour. A myriad of market imperfections, including, increasingly, protectionism, prevent this "model" being fully realised in the real world. But it is useful as a measure of what truly free trade would imply. The single labour market functions, of course, without international mobility of labour. Yet, as in any market, there are price or quantity adjustments: either lower real wages or unemployment, if there is a deviation from the world market price (i.e. wages). It so happens that the world labour market, as a whole, is so heavily in surplus, for as far ahead as we can see, that the marginal market (shadow) price for labour is close to subsistence.

Limited Scope for Upward Adjustment

In many of the most advanced NICs, of course, wage rates are well above subsistence level, as governments set wages which minimise the problems of social control and provide selected protected industries with a domestic market in which to outgrow the infant-industry phase. These countries, following the example of Japan, deliberately push out the simpler, labour-intensive industries to the next-generation NICs (e.g. Malaysia) by raising wages, while still remaining supercompetitive in Western markets.

The fallacy of free traders and mercantilists alike is to think that the old industrial countries can, at a higher level, match this upward adjustment towards increasingly sophisticated, technology- and skill-intensive production. It is this hope which has allowed people to side-step the question of wages: workers in the rich countries will be able to maintain, more or less, the going rate, provided they move into high-tech niches of production, leaving the production of simple things to industrial latecomers.

There are reasons to doubt this comfortable assumption. First, while the final basket of consumption changes over time, its core remains stubbornly banal: people consume limited amounts of jet engines, satellites, advanced pharmaceuticals, etc., and larger amounts of TV sets, carpets, power tools, cars, golf clubs, and, for that matter, shirts. A related piece of advice is to move into the sophisticated range of standard goods: special steels rather than the standard variety, special cars, high-fashion textiles, advanced chemicals, etc. While those firms and countries first off the mark in this sort of adjustment did well for a time (e.g. Germans for steel and Italians in textiles), this cannot be a general remedy: the sophisticated part typically accounts for about 10 % of the market.

More importantly, the rush to high tech is a common strategy of all advanced countries: the US, Europe and

Japan. The result is likely to be a particularly costly kind of overcapacity, rather like the nuclear power industry, where no one has made any money for some time. Thus, the move up-market does not by itself solve trade problems but creates new ones.

One last argument against the up-market type of adjustment optimism is that it corresponds to an outdated view of the nature of the respective populations: brown, pre-industrial illiterates with little capital at their disposal, against (largely) white, educated workers with highly productive capital. This is unconsciously racist nonsense. The most motivated, mobile, and educated portion of the world's brown population does, with the right tools now freely available, outperform the least educated portion of the world's white population. The recent announcement, by Atari (mercantilist industrial policy advocates in the US are called Atari-Democrats), that it will shift production to Taiwan and Hongkong at the expense of 1,700 jobs in California, illustrates the point.

"Dual" Productivity Patterns

Let us now assume an "ideal" advanced country, by the standards of classical economics, without trade unions and without politics. Even in this world, workers who have to buy most of their goods and services from the sheltered parts of the economy, where costs are set by bargaining and convention independent of international market forces, require money wages perhaps eight times as high as the Philippines merely to survive.

Until recently, such a disparity in money wages was feasible by the much higher productivity of rich-country workers, by virtue of the enormous amount of capital at their disposal. In the aggregate, this disparity still holds. But the tradeables sector (manufactures), where state-of-the-art equipment tends to be chosen by multinationals and domestic planning agencies, productivity in developing countries tends increasingly to be on a par or even superior to advanced country standards. This "dual" pattern persists even in Japan, whose *average* productivity is still below European standards.

Such distortions are, in part at least, the result of deliberate government policies. Japan keeps capital artificially cheap and rations it out to favoured sectors. Tax-Yens go to industrial, not social infra-structure, etc. Other South-east Asian countries combine these techniques with more overt forms of state planning, while making use of private entrepreneurs as the most effective agents of national industrial policy.

Present American efforts, in GATT and OECD, to achieve some sort of "disarmament" in this costly subsidy race would, if successful, advance most people's social and economic interests. However, it is quite illusory to think that the only country in the world without industrial policy can remake the world in its image. On the contrary, the shocks and opportunities offered by the new world market integration increase incentives for government intervention; hence the growing US discussion over industrial policy.

In a world where *all* governments accelerate or retard adjustment in pursuit of national targets, the market as a coordinating mechanism cannot function. There arises, inescapably, the problem of alternative forms of coordination. Protectionist deals, like the recent EC-US accord on steel, are entirely logical and indeed inevitable, unless the US wants to be the residual adjuster to other peoples' industrial policies. The problems of the US steel industry were not, of course, caused by foreign competition but, like those of the auto industry, by the failures of rigid, non-innovating oligopolies who shared their spoils with a, by American standards, highly paid workforce. But it is hardly sensible, as people on both sides of the Atlantic argue, to "punish" these industries for past transgressions, denying them the markets and profits they need to modernise, by simply exposing them to the overproduction caused by public policy in Europe and Japan.

Managed Trade a Logical Necessity

To sum up: the growing integration of world markets in manufactures inescapably leads to disequilibria, stemming from artificial labour markets (ours) and non-market mechanisms for allocating and pricing capital investment. Managed trade is not the temporary child of recession, but a logical necessity for achieving balance between managed domestic factor and goods markets. The evidence from sectors such as textiles shows that this can be combined with very high levels of trade and rapid technological progress.

The neo-classical, static theory of comparative advantage is as relevant in the real world of rapidly shifting man-made competitive advantages and disadvantages as the law of physics which states that a feather falls as fast as lead in a vacuum is to aeroplane design. Attempts to create vacuum-like conditions in our own societies cannot possibly succeed under conditions of political freedom. Nor is there hope that the developing countries, Eastern Europe, or China will adopt laissez-faire capitalism.

It is parochial to describe competition by Japan, the NICs, or Eastern Europe as "unfair". It is often sensible for developing countries to concentrate their limited resources in one industry at a time, so as to achieve economies of scale. And the low wages are the result of centuries of Western-imposed dualistic development, and are not only fair but often high by domestic standards. The problem is only that these different "anti-markets", theirs and ours, destabilise each other when linked by an international megamarket.

By the same token, it is quite misleading to think of protectionism as a welfare policy, favouring some workers at the expense of the nation. The run-of-the-mill manufacturing industries are major buyers of inputs from the sophisticated sectors: high-tech machine tools, new materials, computers and services. Without strong home markets, as Japan has demonstrated, export markets cannot be captured.

An Alternative Trading Order

What would an alternative trading order look like? Broadly, it would maintain the present very high levels of trade. The developing countries would be encouraged to exchange secure market access against price and quantity disciplines which would improve their terms of trade while respecting the oligopolistic labour and goods market of the developed countries. China and India, the newest and potentially biggest entrants in these markets, have initiated discussions on how to minimise the self-exploitation inherent in the present scramble for limited Western markets: a step in the right direction. With the quantitative growth of export industries curtailed and with higher *net* receipts, developing countries can and must tackle the long-deferred problem of organic development, based on agriculture and its industrial superstructure. Where rich-country industrial policies clash, these need to be made compatible in the only way possible: by fixing market shares which force policy-makers to take account of real limits.

For multi-component products, like cars and aircraft, local content requirements have proven to be a particularly flexible and efficient instrument, used by every industrial producer in the world, including the US for military purchases. In such a world, the transfer of technology will take over the dynamic role of the transfer of goods, allowing each society to create its own equilibrium. The alternative free-for-all, with all nations keeping down labour and social costs of production and channelling resources into the production of tradeables leads to a mercantilist race, which merely shifts the industrial overproduction crisis around while intensifying it. It leaves both labour and capital underemployed world-wide while fundamental needs go unmet, a world as far removed as possible from the free-traders' promise of political harmony, economic balance, and growth.

High Stakes for Western Europe

For Western Europe the stakes are particularly high. An attempt to push industrial workers' revenues and social security towards the "shadow" price levels of the international labour market would call into question the truce in the class war which has been at the core of politics for at least a century, a truce which is vital for a low-coercion, democratic society. International competition is useful to correct abuses of bargaining power and accumulated rigidities, but the latest austerity programmes announced by most European governments (which like Brüning's policy are ultimately motivated by mercantilist considerations) go about as far as possible if Europe's unique and hard-won experiment in building a humane industrial society is to be maintained.

If the stakes are high for European society, they are no less high for Europe as a political entity. The greater Western European free trade area accounts for two thirds of the exports of its member states. Since costs within this area are similar, free trade within this area is entirely feasible: it implies competition among firms, not societies, and allows the efficiency gains from specialisation and economies of scale which are becoming more, not less, crucial as technology progresses. But this – entirely viable – free-trade area is being undermined by the effects of the European Community's "German" trade policy, with its free-trade bias, which pushes the inevitable protectionist measures to the national level. Non-tariff barriers and financial protectionism (subsidies), however, do as much or more damage within Europe as towards the outside world. Moreover, when the Community – belatedly – acts in a protectionist sense, it leans over backwards not to be discriminatory, harming future member states like Spain and Portugal, and the EFTA countries. The economic re-balkanisation of Europe is becoming a reality and the political balkanisation a distinct possibility. All this is done in a futile attempt to maintain the semblance of free trade with an outside world which is highly protectionist as regards imports and quasi-free trading as regards exports, and with activist structural policies which neglect domestic demands in favour of unbalanced, world-market oriented growth. The third industrial revolution requires more, not less, autonomy for economic policy in the rich countries, just as the second revolution does in developing countries.