Chapter 3

INTERNATIONAL TRADE AND INVESTMENT

Article 3.1

THE GOSPEL OF FREE TRADE

The New Evangelists

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Free trade! With the zeal of Christian missionaries, for decades the U.S. government has been preaching, advocating, pushing, and coercing around the globe for "free trade."

As the economic crisis emerged in 2007 and 2008 and rapidly became a global crisis, it was apparent that something was very wrong with the way the world economy was organized. Not surprisingly, as unemployment rose sharply in the United States, there were calls for protecting jobs by limiting imports and for the government to "buy American" in its economic stimulus program. Similarly, in many other countries, as unemployment jumped upwards, pressure emerged for protection—and some actual steps were taken. Yet, free trade missionaries did not retreat; they continued to preach the same gospel.

The free-traders were probably correct in claiming that protectionist policies would do more harm than good as a means to stem the rising unemployment generated by the economic crisis. Significant acts of protectionism in one country would lead to retaliation—or at least copying—by other countries, reducing world trade. The resulting loss of jobs from reduced trade would most likely outweigh any gains from protection.

Yet the argument over international economic policies should not be confined simply to what should be done in a crisis. Nor should it simply deal with trade in goods and services. The free-traders have advocated their program as one for long-run economic growth and development, yet the evidence suggests that free trade is not a good economic development strategy. Furthermore, the free-traders preach the virtue of unrestricted global movement of finance as well as of goods and services. As it turns out, the free flow of finance has been a major factor in bringing about and spreading the economic crisis that began to appear in 2007—as well as earlier crises.

The Push

While the U.S. push for free trade goes back several decades, it has become more intense in recent years. In the 1990s, the U.S. government signed on to the North American Free Trade Agreement (NAFTA) and in 2005 established the Central American Free Trade Agreement (CAFTA). Both Republican and Democratic presidents, however, have pushed hard for a *global* free trade agenda. After the demise of the Soviet Union, U.S. advisers prescribed unfettered capitalism for Eastern and Central Europe, and ridiculed as unworkable any move toward a "third way." In low-income countries from Mexico to Malaysia, the prescription has been the same: open markets, deregulate business, don't restrict international investment, and let the free market flourish.

In the push for worldwide free trade, the World Trade Organization (WTO) has been the principal vehicle of change, establishing rules for commerce that assure markets are open and resources are available to those who can pay. And the International Monetary Fund (IMF) and World Bank, which provide loans to many governments, use their financial power to pressure countries around the world to accept the gospel and open their markets. In each of these international organizations, the United States—generally through the U.S. Treasury—plays a dominant role.

Of course, as with any gospel, the preachers often ignore their own sermons. While telling other countries to open their markets, the U.S. government continued, for instance, to limit imports of steel, cotton, sugar, textiles, and many other goods. But publicly at least, free-trade boosters insist that the path to true salvation—or economic expansion, which, in this day and age, seems to be the same thing—lies in opening our market to foreign goods. Get rid of trade barriers at home and abroad, allow business to go where it wants and do what it wants. We will all get rich.

Yet the history of the United States and other rich countries does not fit well with the free-trade gospel. Virtually all advanced capitalist countries found economic success through heavy government regulation of their international commerce, not in free trade. Likewise, a large role for government intervention has characterized those cases of rapid and sustained economic growth in recent decades—for example, Japan after World War II, South Korea in the 1970s through the 1990s, and China most recently.

Free trade does, however, have its uses. Highly developed nations can use free trade to extend their power and control of the world's wealth, and business can use it as a weapon against labor. Most important, free trade can limit efforts to redistribute income more equally, undermine social programs, and keep people from democratically controlling their economic lives.

A Day in the Park

At the beginning of the 19th century, Lowell, Massachusetts became the premier site of the U.S. textile industry. Today, thanks to the Lowell National Historical Park, you can tour the huge mills, ride through the canals that redirected the Merrimack River's power to those mills, and learn the story of the textile workers, from the Yankee "mill girls" of the 1820s through the various waves of immigrant laborers who poured into the city over the next century.

During a day in the park, visitors get a graphic picture of the importance of 19th-century industry to the economic growth and prosperity of the United States. Lowell and the other mill towns of the era were centers of growth. They not only created a demand for Southern cotton, they also created a demand for new machinery, maintenance of old machinery, parts, dyes, *skills*, construction materials, construction machinery, *more skills*, equipment to move the raw materials and products, parts maintenance for that equipment, *and still more skills*. The mill towns also created markets—concentrated groups of wage earners who needed to buy products to sustain themselves. As centers of economic activity, Lowell and similar mill towns contributed to U.S. economic growth far beyond the value of the textiles they produced.

The U.S. textile industry emerged decades after the industrial revolution had spawned Britain's powerful textile industry. Nonetheless, it survived and prospered. British linens inundated markets throughout the world in the early 19th century, as the British navy nurtured free trade and kept ports open for commerce. In the United States, however, hostilities leading up to the War of 1812 and then a substantial tariff made British textiles relatively expensive. These limitations on trade allowed the Lowell mills to prosper, acting as a catalyst for other industries and helping to create the skilled work force at the center of U.S. economic expansion.

Beyond textiles, however, tariffs did not play a great role in the United States during the early 19th century. Southern planters had considerable power, and while they were willing to make some compromises, they opposed protecting manufacturing in general because that protection forced up the prices of the goods they purchased with their cotton revenues. The Civil War wiped out the planters' power to oppose protectionism, and from the 1860s through World War I, U.S. industry prospered behind considerable tariff barriers.

Different Countries, Similar Experiences

The story of the importance of protectionism in bringing economic growth has been repeated, with local variations, in other advanced capitalist countries. During the late 19th century, Germany entered the major league of international economic powers with substantial protection and government support for its industries. Likewise, in 19th-century France and Italy, national consolidation behind protectionist barriers was a key to economic development.

Britain—which entered the industrial era first—is often touted as the prime example of successful development without tariff protection. Yet, Britain embraced free trade only after its industrial base was well established; as in the U.S., the early and important textile industry was erected on a foundation of protectionism. In addition, Britain built its industry through the British navy and the expansion of empire, hardly prime ingredients in any recipe for free trade.

Japan provides an especially important case of successful government protection and support for industrial development. In the post-World War II era, when the Japanese established the foundations for their economic "miracle," the government rejected free trade and extensive foreign investment and instead promoted its national firms.

In the 1950s, for example, the government protected the country's fledgling auto firms from foreign competition. At first, quotas limited imports to $500,000 (in current dollars) each year; in the 1960s, prohibitively high tariffs replaced the quotas. Furthermore, the Japanese allowed foreign investment only insofar as it contributed to developing domestic industry. The government encouraged Japanese companies to import foreign technology, but required them to produce 90% of parts domestically within five years.

The Japanese also protected their computer industry. In the early 1970s, as the industry was developing, companies and individuals could only purchase a foreign machine if a suitable Japanese model was not available. IBM was allowed to produce within the country, but only when it licensed basic patents to Japanese firms. And IBM computers produced in Japan were treated as foreign-made machines.

In the 20th century, no other country matched Japan's economic success, as it moved in a few decades from a relative low-income country, through the devastation of war, to emerge as one of the world's economic leaders. Yet one looks back in vain to find a role for free trade in this success. The Japanese government provided an effective framework, support, and protection for the country's capitalist development.

Likewise, in many countries that have been late-comers to economic development, capitalism has generated high rates of economic growth where government involvement, and not free trade, played the central role. South Korea is a striking case. "Korea is an example of a country that grew very fast and yet violated the canons of conventional economic wisdom," writes Alice Amsden in *Asia's Next Giant: South Korea and Late Industrialization,* widely acclaimed as perhaps the most important analysis of the South Korean economic success. "In Korea, instead of the market mechanism allocating resources and guiding private entrepreneurship, the government made most of the pivotal investment decisions. Instead of firms operating in a competitive market structure, they each operated with an extraordinary degree of market control, protected from foreign competition."

Free trade, however, has had its impact in South Korea. In the 1990s, South Korea and other East Asian governments came under pressure from the U.S. government and the IMF to open their markets, including their financial markets. When they did so, the results were a veritable disaster. The East Asian financial crisis that began in 1997 was a major setback for the whole region, a major disruption of economic growth. After extremely rapid economic growth for three decades, with output expanding at 7% to 10% a year, South Korea's economy plummeted by 6.3% between 1997 and 1998.

Mexico and Its NAFTA Experience

While free trade in goods and services has its problems, which can be very serious, it is the free movement of capital, the opening of financial markets that has sharp, sudden impacts, sometimes wrecking havoc on national economies. Thus, virtually as soon as Mexico, the United States and Canada formed NAFTA at the beginning of 1994, Mexico was hit with a severe financial crisis. As the economy turned downward at the beginning of that year, capital rapidly left the country, greatly reducing the value of the Mexican peso. With this diminished value of the peso, the cost of servicing international debts and the costs of imports skyrocketed—and the downturn worsened.

Still, during the 1990s, before and after the financial crisis, free-traders extolled short periods of moderate economic growth in Mexico —3% to 4% per year—as evidence of success. Yet, compared to earlier years, Mexico's growth under free trade has been poor. From 1940 to 1990 (including the no-growth decade of the 1980s), when Mexico's market was highly protected and the state actively regulated economic affairs, output grew at an average annual rate of 5%.

Most important, Mexico's experience discredits the notion that free-market policies will improve living conditions for the masses of people in low-income countries. The Mexican government paved the way for free trade policies by reducing or eliminating social welfare programs, and for many Mexican workers wages declined sharply during the free trade era. The number of households living in poverty rose dramatically, with some 75% of Mexico's population below the poverty line at the beginning of the 21st century.

China and Its Impact

Part of Mexico's problem and its economy's relatively weak performance from the 1990s onward has been the full-scale entrance of China into the international economy. While the Mexican authorities thought they saw great possibilities in NAFTA, with the full opening of the U.S. market to goods produced with low-wage Mexican labor, China (and other Asian countries) had even cheaper labor. As China also gained access to the U.S. market, Mexican expectations were dashed.

The Chinese economy has surely gained in terms of economic growth as it has engaged more and more with the world market, and the absolute levels of incomes of millions of people have risen a great deal. However, China's rapid economic growth has come with a high degree of income inequality. Before its era of rapid growth, China was viewed as a country with a relatively equal distribution of income. By the beginning of the new millennium, however, it was much more unequal than any of the other most populace Asian countries (India, Indonesia, Bangladesh, Pakistan), and more in line with the high-inequality countries of Latin America. Furthermore, with the inequality has come a great deal of social conflict. Tens of thousands of "incidents" of conflict involving violence are reported each year, and most recently there have been the major conflicts involving Tibetans and Ouigers.

In any case, the Chinese trade and growth success should not be confused with "free trade." Foundations for China's surge of economic growth were established through state-sponsored infra-structure development and the vast expansion of the country's educational system. Even today, while private business, including foreign business, appears to have been given free rein in China, the government still plays a controlling role—including a central role in affecting foreign economic relations.

A central aspect of the government's role in the county's foreign commerce has been in the realm of finance. As Chinese-produced goods have virtually flooded international markets, the government has controlled the uses of the earnings from these exports. Instead of simply allowing those earnings to be used by Chinese firms and citizens to buy imports, the government has to a large extent held those earnings as reserves. Using those reserves, China's central bank has been the largest purchaser of U.S. government bonds, in effect becoming a major financer of the U.S. government's budget deficit of recent years.

China's reserves have been one large element in creating a giant pool of financial assets in the world economy. This "pool" has also been built up as the doubling of oil prices following the U.S. invasion of Iraq put huge amounts of funds in the pockets of oil-exporting countries and firm and individuals connected to the oil industry. Yet slow growth of the U.S. economy and extremely low interest rates, resulting from the Federal Reserve Bank's efforts to encourage more growth, limited the returns that could be obtained on these funds. One of the consequences—through a complex set of connections—was the development of the U.S. housing bubble, as financial firms, searching for higher returns, pushed funds into more and more risky mortgage loans.

It was not simply free trade and the unrestricted flow of international finance that generated the housing bubble and subsequent crisis in the U.S. economy. However, the generally unstable global economy—both in terms of trade and finance—that has emerged in the free trade era was certainly a factor bringing about the crisis. Moreover, as is widely recognized, it was not only the U.S. economy and U.S. financial institutions that were affected. The free international flow of finance has meant that banking has become more and more a global industry. So as the U.S. banks got in trouble in 2007 and 2008, their maladies spread to many other parts of the world.

The Uses of Free Trade

While free trade is not the best economic growth or development policy and, especially through the free flow of finance, can precipitate financial crises, the largest and most powerful firms in many countries find it highly profitable. As Britain preached the loudest sermons for free trade in the early 19th century, when its own industry was already firmly established, so the United States—or at least many firms based in the United States—find it a profitable policy at the beginning of the 21st century. The Mexican experience provides an instructive illustration.

For U.S. firms, access to foreign markets is a high priority. Mexico may be relatively poor, but with a population of 105 million it provides a substantial market. Furthermore, Mexican labor is cheap relative to U.S. labor; and using modern production techniques, Mexican workers can be as productive as workers in the United States. For U.S. firms to obtain full access to the Mexican market, the United States has to open its borders to Mexican goods. Also, if U.S. firms are to take full advantage of cheap foreign labor and sell the goods produced abroad to U.S. consumers, the United States has to be open to imports.

On the other side of the border, wealthy Mexicans face a choice between advancing their interests through national development or advancing their interests through ties to U.S. firms and access to U.S. markets. For many years, they chose the former route. This led to some development of the Mexican economy but also—due to corruption and the massive power of the ruling party, the PRI—huge concentrations of wealth in the hands of a few small groups of firms and individuals. Eventually, these groups came into conflict with their own government over regulation and taxation. Having benefited from government largesse, they came to see their fortunes in greater freedom from government control and, particularly, in greater access to foreign markets and partnerships with large foreign companies. National development was a secondary concern when more involvement with international commerce would produce greater riches more quickly.

In addition, the old program of state-led development in Mexico ran into severe problems. These problems came to the surface in the 1980s with the international debt crisis. Owing huge amounts of money to foreign banks, the Mexican government was forced to respond to pressure from the IMF, the U.S. government, and large international banks which sought to deregulate Mexico's trade and investment. That pressure meshed with the pressure from Mexico's own richest elites, and the result was the move toward free trade and a greater opening of the Mexican economy to foreign investment.

Since the early 1990s, these changes for Mexico and the United States (as well as Canada) have been institutionalized in NAFTA. The U.S. government's agenda since then has been to spread free trade policies to all of the Americas through more regional agreements like CAFTA and ultimately through a Free Trade Area of the Americas. On a broader scale, the U.S. government works through the WTO, the IMF, and the World Bank to open markets and gain access to resources beyond the Western Hemisphere. In fact, while markets remain important everywhere, low-wage manufacturing is increasingly concentrated in Asia—especially China—instead of Mexico or Latin America.

The Chinese experience involves many of the same advantages for U.S. business as does the Mexican—a vast market, low wages, and an increasingly productive labor force. However, the Chinese government, although it has liberalized the economy a great deal compared to the pre-1985 era, has not abdicated its major role in the economy. For better (growth) and for worse (inequality and repression), the Chinese government has not embraced free trade.

Who Gains, Who Loses?

Of course, in the United States, Mexico, China and elsewhere, advocates of free trade claim that their policies are in everyone's interest. Free trade, they point out, will mean cheaper products for all. Consumers in the United States, who are mostly workers, will be richer because their wages will buy more. In Mexico and China, on the one hand, and in the United States, on the other hand, they argue that rising trade will create more jobs. If some workers lose their jobs because cheaper imported goods are available, export industries will produce new jobs.

In recent years this argument has taken on a new dimension with the larger entrance of India into the world economy and with the burgeoning there of jobs based in information technology—programming and call centers, for example. This "out-sourcing" of service jobs has received a great deal of attention and concern in the United States. Yet free-traders have defended this development as good for the U.S. economy as well as for the Indian economy.

Such arguments obscure many of the most important issues in the free trade debate. Stated, as they usually are, as universal truths, these arguments are just plain silly. No one, for example, touring the Lowell National Historical Park could seriously argue that people in the United States would have been better off had there been no tariff on textiles. Yes, in 1820, they could have purchased textile goods more cheaply, but in the long run the result would have been less industrial advancement and a less wealthy nation. One could make the same point with the Japanese auto and computer industries, or indeed with numerous other examples from the last two centuries of capitalist development.

In the modern era, even though the United States already has a relatively developed economy with highly skilled workers, a freely open international economy does not serve the interests of most U.S. workers, though it will benefit large firms. U.S. workers today are in competition with workers around the globe. Many different workers in many different places can produce the same goods and services. Thus, an international economy governed by the free trade agenda will tend to bring down wages for many U.S. workers. This phenomenon has certainly been one of the factors leading to the substantial rise of income inequality in the United States during recent decades.

The problem is not simply that of workers in a few industries—such as auto and steel, or call-centers and computer programming—where import competition is an obvious and immediate issue. A country's openness to the international economy affects the entire structure of earnings in that country. Free trade forces down the general level of wages across the board, even of those workers not directly affected by imports. The simple fact is that when companies can produce the same products in several different places, it is owners who gain because they can move their factories and funds around much more easily than workers can move themselves around. Capital is mobile; labor is much less mobile. Businesses, more than workers, gain from having a larger territory in which to roam.

Control Over Our Economic Lives

But the difficulties with free trade do not end with wages. In both low-income and high-income parts of the world, free trade is a weapon in the hands of business when it opposes any progressive social programs. Efforts to place environmental restrictions on firms are met with the threat of moving production abroad. Higher taxes to improve the schools? Business threatens to go elsewhere. Better health and safety regulations? The same response.

Some might argue that the losses from free trade for people in the United States will be balanced by gains for most people in poor countries—lower wages in the United States, but higher wages in Mexico and China. Free trade, then, would bring about international equality. Not likely. In fact, as pointed out above, free trade reforms in Mexico have helped force down wages and reduce social welfare programs, processes rationalized by efforts to make Mexican goods competitive on international markets. China, while not embracing free trade, has seen its full-scale entrance into global commerce accompanied by increasing inequality.

Gains for Mexican or Chinese workers, like those for U.S. workers, depend on their power in relation to business. Free trade or simply the imperative of international "competitiveness" are just as much weapons in the hands of firms operating in Mexico and China as they are for firms operating in the United States. The great mobility of capital is business's best trump card in dealing with labor and popular demands for social change—in the United States, Mexico, China and elsewhere.

None of this means that people should demand that their economies operate as fortresses, protected from all foreign economic incursions. There are great gains that can be obtained from international economic relations—when a nation manages those relations in the interests of the great majority of the people. Protectionism often simply supports narrow vested interests, corrupt officials, and wealthy industrialists. In rejecting free trade, we should move beyond traditional protectionism.

Yet, at this time, rejecting free trade is an essential first step. Free trade places the cards in the hands of business. More than ever, free trade would subject us to the "bottom line," or at least the bottom line as calculated by those who own and run large companies. ❑