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On the Crisis of the "Liberalization Policy" in the Economics of Interdependence

by Detlef Lorenz, Berlin *

In spite of all protestations and exhortations it is a fact that trade liberalization, the modern version of free trade, is caught in a crisis. Professor Detlef Lorenz is here analysing the causes of this crisis and suggesting alternatives for a future liberalization policy.

Trade liberalization is – to use a simplified formula – a modern form of freedom of foreign trade in a "Non-laissez-faire World" (Goran Ohlin) practised since about 1948. It has been undeniably achieved great and much applauded successes but does not at present – depending on how it is defined – account for much more than 50 % of the total world trade.¹ It has to be borne in mind that trade liberalization would be far less important if the European regionalism under EEC/EFTA/EC auspices were left out of account. Furthermore, it is a fact that a not easily assessable part of the liberalized trade has been internalized by multinational corporations organizing it in their own way. This cannot be examined further in the present article.

Over five years ago two questions were discussed which have retained their topicality to a surprising extent. One of them was: "Why should there always be free trade?" and the other one: "Where is free trade practised?"² The position now is this: on the one hand one hears more and more avowals (!) of and exhortations to practice "free trade" which are however uttered without much conviction and attended by few new arguments while the

liberalized trade is at the same time subjected to more and more restrictions and potential threats. On the other hand, it emerges ever more clearly that the supposition of a predominance of "free trade" is still of questionable validity and has in fact declined even further as the area in which trade liberalization holds sway has been put in jeopardy.

Which are the influences that have led to the crisis of trade liberalization?

The High Tide of Trade Liberalization

The first thesis to be examined is that trade liberalization is a "fair weather" policy similar to the free trade of the 19th century or the old gold standard. The competitive process and structural changes involved in trade liberalization – the so-called reallocation of substitutional competition – do not hurt when the climate for growth is really good or at least satisfactory. The growth potential in the three decades of years following the second world war had a great deal to do with the fact that the demand backlog lasted longer than expected and stimulated the so-called gap trade in particular while at the same time the trade in durable consumer goods underwent a once-and-for-all expansion due to the general prosperity. The result was that there existed a substantial although *limited* potential for trade expansion, especially among the industrialized countries.

The success of this international specialization "without tears" unhampered by any protectionist resistance is nowadays largely attributed to the two essential mainstays of trade liberalization – the *intra-regional* and the *intra-industrial* trade. These demanded far less adaptability than other forms of trade: "... Trade liberalization in the European Economic Community ... resulted in greater trade expansion and fewer adjustment problems than had been anticipated by analysts who had based their predictions on the more

* Freie Universität Berlin. – I wish to thank my assistant Diplom-Volkswirt E. Minx for discussions and valuable suggestions.

¹ Kebschull estimates the share of the liberalized trade at about 50 %; he includes however, in addition to the agricultural trade, the "voluntary" export agreements and similar forms of trade which are not "liberal in the sense of the market economy" between the industrialized countries and between North and South, also the East-West trade and the trade within and between the groups of the developing and socialist countries which is of less relevance to the decline of the liberalized Western trade in its proper sense which is being discussed in the present article. Cf. D. Kebschull, Welthandel auf falschen Gleisen (World trade on a wrong track), in: WIRTSCHAFTSDIENST, 58th year (1978), No. 3, p. 107. On free trade in past and present cf. also H. Berg, Internationale Wirtschaftspolitik (International economic policy), Göttingen 1976, p. 41 ff. and p. 67 ff.

² Cf. Dietrich Kebschull, Warum eigentlich überall Freihandel? (Why engage everywhere in free trade?), in: WIRTSCHAFTSDIENST, 52nd year (1972), No. 10, p. 504 ff.; by the same author, Export – keine Erfolgsgarantie (Export – No guarantee of success), in: WIRTSCHAFTSDIENST, 53rd year (1973), No. 1, p. 16 f.; Detlef Lorenz, Wo gibt es eigentlich Freihandel? (Where is there real free trade?), in: WIRTSCHAFTSDIENST, 53rd year (1973), No. 1, p. 9 ff.; Juergen B. Donges, Protektionismus zahlt sich nicht aus (Protectionism does not pay), in: WIRTSCHAFTSDIENST, 53rd year (1973), No. 1, p. 13 ff.

traditional model of inter-industry specialization.”³ Reallocation within an industry is easier than reallocations between different industries appear to be.

Although there is still scope for more intra-industry trade, especially in regard to the input trade on which stress is laid in a GATT study⁴, the various economic miracles of several industrialized countries are certainly a matter of the past, and the growth reserves in the world economy have clearly dwindled. To put it differently, the return to normal (moderate) conditions has been giving us trouble for some time now – and this too regardless of protectionism which is to some extent only a response to the existing state of affairs.

Three Questions

Three points may be made about the “fair weather” approach. In the first place there is some justification for asking whether the liberalization of trade and its progress are not on the “direct” line of the pre-1914 period and the second half of the nineteenth century. Assuming this to be the case, the inter-war period up to the forties would be an “exceptional period”, and so would the fifties and sixties of the 20th century. Between 1850 and 1914, it will be recalled, we also had only a relatively

³ H. G. Grubel, P. J. Lloyd, *Intra-Industry Trade*, London 1975, p. 143. G. C. Hufbauer, J. G. Chilas, *Specialization by Industrial Countries: Extent and Consequences*, in: *The International Division of Labour – Problems and Perspectives*, International Symposium, Edited by Herbert Giersch, Tübingen 1974. Of special interest are two statements by Hufbauer: “Formidable adjustment burdens accompany free trade in manufactured goods. These adjustment burdens underlie our pessimism concerning future specialization among the industrial nations or between the industrial countries and the Third World.” (p. 9). And: “Because regional groupings can partly overcome adjustment difficulties, this ‘institutional approach’ offers a more promising route to specialization than the theoretically superior method, advocated in Anglo-Saxon circles, of multilateral reductions in tariff and non-tariff barriers.” (p. 19).

⁴ R. Blackhurst, N. Marian, J. Tumliir, *Trade Liberalization, Protectionism, and Interdependence*. GATT Studies in International Trade, No. 5, Geneva 1977, p. 15/16. The authors’ remark can be interpreted in the sense that the limitations on the final sales (of end-products) are not extended by input or intermediate trade. The scope for expansions is to that extent deceptive.

short period during which free trade flourished. Must protectionism or “restricted” trade liberalization then be regarded as the normal state or the pragmatic answer? Free trade models are alas, as a rule, ahistorical – as are other models of modern economics!

The second question is less academic but of increasing importance and topically. It concerns the *absorptive capacity* of liberalized markets of industrialized countries when faced with an export drive by the developing countries which may be due to their own initiative or “induced by outside factors”. There exists a close parallel, though not a quantitative one, between these exports and those of the Eastern bloc! World-wide “free trade” by the industrialized countries is bound to exert a considerable adjustment pressure in the sense of a “continuing rolling adjustment”.⁵ A warning is called for in this context, however, partly because of the aspects referred to earlier – against the illusion “... that a relatively unobstructed liberal trade could be maintained among the old industrialized countries if the dynamic ‘disruptive’ industrial newcomers could only be kept at bay”. (Tumliir, p. 16).

One final question arises in connection with an intensification of the international competition, namely that of the real usefulness of “trade liberalization as an anti-trust device”.⁶ One point to be considered here is that any “genuine” competitive advantage, i.e.: one not due to export policy manipulation – of the *industrialized countries* (the developing countries and the state trading countries are not considered here) is in all probability

⁵ Cf. the articles mentioned in footnote 3 and also the contributions of J. Tumliir and H. B. Malmgren to the new journal *The World Economy*, Vol. 1, No. 1, p. 16 and p. 31/32. For a historic perspective cf. my article, *Die Neue Weltwirtschaftsordnung aus der Sicht der Industriestaatdebatte der Jahrhundertwende* (The New International Economic Order as seen by the German “Industriestaat-Debatte” of the turn of the century), in: *Jahrbucher für Nationalökonomie und Statistik*, Vol. 192 (1977), p. 49 to 54 in particular.

⁶ Cf. the GATT study mentioned in footnote 4, p. 28. Similar conclusions apply to the contribution of the foreign trade to internal price level stability (*ibid.*, p. 28/29).

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narrowly limited. The general competition intensity does not really appear to be greater outside the Federal Republic. A second, more fundamental point concerns the "fig-leaf" function of trade liberalization, i.e.: the practice of compensating for quite obvious inadequacies of the *national* competition policy or disguising them by putting the blame on *international* competition.

Overstrained Interdependence

All this however must not hide the fact that we are faced here in no small part with consequences or repercussions of the policy of liberalization itself. A development which was welcomed in the fifties and sixties in a positive sense as international economic integration – a re-integration of the world economy as a reaction to the disintegration which it experienced after the first economic world crisis of 1929 – became more and more of a burden and an ordeal for the world economy in the seventies because it had resulted in a very high degree of (too intensive?) interdependence. The exacting demands of an internationalization of the goods and factor markets under the aspects of the exceedingly sensitive "economics of interdependence" were pointed out by Cooper already at an early stage but were not subjected to a more detailed and critical examination in the context of the conflict with the national state and its tasks until Lindbeck did so.⁷ It is certainly going a little too far to speak of a "squeeze" of the economic policies of the national states (Lindbeck) but it has to be noted as a fact that the states have been receiving a steadily diminishing return in the form of an efficient international policy or economic order for their surrender or commitment of national economic means and competences.

These facts are of significance whenever growth is slow and cyclical and structural unemployment high. But even before the malaise of the last few years the situation was marked by a particular feature: as prosperity and trade increased "society" wanted the state to become more active in the sphere of economic policy. Not only were new areas such as distribution and incomes policy, and structural and regional policy brought into the ambit of economic policy but the "domestic policy targets" were often given a more ambitious and more differentiated interpretation. This happened

⁷ R. N. Cooper, *The Economics of Interdependence*, New York 1968. A. Lindbeck, *The National State in an Internationalized World Economy, and also Economic Dependence and Interdependence in the Industrialized World*. Institute for International Economic Studies, University of Stockholm, Seminar Papers No. 26 (1973) and No. 83 (1977). In regard to the following remarks cf. my contribution on "Innenwirtschaftliche Steuerungsprobleme und Auswirkungen auf das liberale Handelssystem (Steering problems in the domestic economy and their repercussions on the liberal trade system) which has now been published in: *Jahrbuch der Deutschen Gesellschaft für Auswärtige Politik "Die Internationale Politik 1970-1972"*, München 1978.

in the knowledge of Tinbergen's basic rule of economic policy that additional targets demand additional economic instruments and that national constraints due to the "economics of interdependence" tend to make for lower efficiency of economic policies. This macroeconomic dilemma was bound to bring vested interests into play and to encourage legitimate demands for protection against a too thoughtless application of the liberalization policy. Besides, the interests of the industrialized countries are not now in greater accord than they were in the past, and there is thus a danger of one country (or group) being exposed to stronger liberalization pressure than the others.

Finally, the "economics of interdependence" have been increasingly politicised and put in jeopardy by the weakening of the United States' dominating position and by the shortcomings of the international organisations IMF and GATT which cannot be substituted by summitries of statesmen. This was recently shown exceedingly clearly in a sphere of cardinal importance, namely that of currency policy. The changeover to flexible rates of exchange, undertaken with such great hopes, has done little to bring the adjustment problem (or rather the problem of the refusal to make adjustments) nearer to a solution; instead it has created new uncertainties and encouraged modes of conduct which are not compatible with the system (the oil crisis aside!).

If it is true that easy substitution in the exchangeability of domestic and foreign goods has become an increasingly important part of the process of internationalization and that, for example, the development gains (gap trade) have become smaller and the substitution gaps resulting from product differentiation have also narrowed, wide exchange rate instabilities will very quickly become a determinant of competition at the macro level and have a distorting effect. In view of the eruptions and insincerities encountered in the international currency policy it must be asked what importance can be attached to tariff cuts of the size envisaged in the outcome of the Tokyo round and whether the frequent references to the non-tariff barriers to trade do not detract the attention too much from other more fundamental shortcomings of the international system.

Liberalization Mercantilism

More thought need also be given to the mental attitude – by now almost a fashion – of seasoning the ideas of protectionism with the salt of neomercantilism. There can be no doubt that mercantilistic ideas play a role in the complex of non-tariff barriers to trade, which has just been mentioned, insofar as these operate on exports.

GATT is after all mainly concerned with the sphere of import policy and has given too little attention to the export side which has long been treated as a kind of sanctuary. Some industrialized countries may also be charged with adopting mercantilistic attitudes in their exchange rate and balance of payments policies. The promotion of international economic policy to the sphere of "high politics" (Cooper) finally, is not merely a mixed blessing but a good indicator of the typically mercantilistic cross-currents between foreign policy and foreign economic policy — more especially in view of the fact that the national state does not appear to succumb as readily as was prematurely prophesied. Mercantilistic *elements* are thus certainly at work, but it is equally clear that more consideration must be given to an adequate characterization of what constitutes *neo-mercantilism*.

In the context of the crisis of the liberalized trade — and in development of the arguments presented earlier — the *neo-mercantilism* must however be interpreted definitely as a *defensive* phenomenon which finds its explanation in part in the overall situation of the world economy in the period following the second world war. In this connection one should make the not unimportant distinction between "negative" and "positive" liberalization policy which was made first by Tinbergen and Pinder. The former is "only" concerned with the removal of constraints and distortions of international economic relations for the purpose of maximizing world trade and the international division of labour. The positive liberalization policy on the other hand goes beyond the removal of constraints and distortions and aims at more ambitious solutions such as an international competition policy or more. It is a fact that little has as yet been done or contemplated in order to give the liberalization policy a positive content.

The challenge presented by internationalization and interdependencies in the absence of a "positive" liberalization policy, in conjunction with the problems arising from the fact that vested interests cannot simply be ignored when the international competition grows more severe and national conditions are marked by stagflation, has induced many governments to resort increasingly to the development of defensive mechanisms. The state of affairs which we are witnessing today, a kind of "liberalization mercantilism" — Lindbeck is speaking of "semi-organized anarchy" — is thus seen not to be fortuitous; it is due to sins of omission in the past and to insufficiently thought-through concepts. There are good reasons for doubting whether the crisis of the liberalized trade

can be resolved solely by the operation of a safeguard policy — the "safety net" of the liberalization policy⁸ — or by harmonization of non-tariff barriers to trade (code policy).

Alternatives

What escape routes or further developments are left if we cannot put our trust in a revival of the forces for growth alone and the neo-mercantilism should not be developed further under the protection of "free trade" labels? A "positive" liberalization policy can certainly start with the so-called adjustment policy which is the subject of US trade policy legislation and the discussion on Article 19 of GATT. Without departing from the existing economic system it can still be broadened into a transformation policy concerned with the degree of mobility of the macro-economic structure and not alone with the production factor "labour". The crucial question however is whether adjustments which are not a "quantité négligeable" or which occur not only sporadically can in actual fact be carried out without that problematic "plus" of a structural or industrial policy which *can* also be a constituent part of neo-mercantilism and is now being discussed at times by French circles under the key-word of "organized free trade".⁹

A policy in favour of a general world-wide system of liberal or protectionist/technocratic origin will certainly encounter one fundamental problem: too much will be expected from it under the conditions of modest growth and adverse circumstances which prevail now and will exist in the near future; and this applies equally whether the markets of the industrialized countries need more liberalization or tighter organization. It applies to the relations of the industrialized countries amongst themselves and even more to the export ambitions of other regions of the world economy (cf. footnotes 3 and 5). Various conjectures and proposals for more limited action which have been made in this connection are interesting as well as typical. There is for instance the early proposal of Behrman for international *sectoral* integration and the GATT Plus proposal which was designed especially for the industrialized countries¹⁰, and there are also the more recent considerations in the Tri-lateral Commission which aim at a "piecemeal

⁹ Cf. D. Lorenz, *Innenwirtschaftliche Steuerungsprobleme . . .*, *ibid.*, and the rather reserved views of industrial policy of the "Trilateral Commission" in: *Towards a Renovated International System*, in: *The Triangle Papers*, No. 14 (1977), p. 57. Cf. also the contribution of Th. de Montbrial under the telling title: *Macroeconomic Coordination and Trade: The Need for Orderly Limitation of Interdependence*, in: *Dialogue*, Winter 1976/77, No. 13, p. 6/7.

¹⁰ Cf. J. N. Behrman, *International Sectoral Integration: An Alternative Approach to Freer Trade*, in: *Journal of World Trade Law*, Vol. 6 (1972), p. 269 ff. The Atlantic Council of the United States: *GATT Plus. A Proposal for Trade Reform*, Washington 1976. Art. 7 of the GATT anti-dumping code and the "semi-official" cotton textiles agreement may be interpreted in this context as anticipating sectoral "voluntary" export agreements.

⁸ Cf. A. I. MacBean, *How to Repair the "Safety Net" of the International Trading System*: in: *The World Economy*, Vol. 1 (1978), No. 2, p. 149 ff.

functionalism" for certain problem areas and at flexible participation of the partners in various "concentric circles of decision-making".¹¹ Some "fragmentation" of the trilateral economic area into so-called "core countries" and others has also come up for practical discussion. This idea may be described as an up-to-date reaction to the state of affairs of a world economy which finds itself between the loss of leadership and the dread of a pluralist "chaos" (whether neo-mercantilistic or not).

More Appropriate Ways of Approach

If we go further and give consideration also to specific proposals for the developing countries, whether still formally linked to GATT or not, such as Brazil's initiative in GATT or the Conference for International Economic Cooperation and other more definitely bilateral arrangements, we find ourselves not so very far from the discussions about regionalism v. universalism in the early post-war period.¹² The controversy of those days was never properly settled in practice because the universal organizations IMF and GATT — and the liberalization policy as well — lived with and *through* the European regionalism (the customs

unions). We may perhaps reach more appropriate ways of approach if we do not disparage the European regionalism as a "protectionist discrimination community" or the "ultimate of neo-mercantilism" but contemplate the *structures* and *functions* of the world economy together with the regional complexes.

Then it is certainly not irrelevant to the viability and preservation of the liberalized trade what kind of trade flows — substitutive or complementary — will emerge from the negotiations, how large they will be and what functions they will perform within and between existing and other regions of the future. The GATT study which has already been referred to several times assumes on the strength of the different trends in intra- and inter-regional trade in industrial goods in the past that "there is considerable potential for greater specialization between the three major industrial areas and between them and the rest of the world" in regard to the "underdeveloped" inter-continental exchanges and that "the untapped opportunities for greater international specialization appear truly impressive".¹³ This is a highly optimistic global statement which is unlikely to overcome the crisis of trade liberalization "futurolologically". A differentiative consideration of the facts on the basis of development and competition theories and spacial economic analysis may prove more helpful even if it is unlikely to produce a panacea.

¹¹ The Triangle Papers, No. 14 (1977), e.g. p. 32-34 and p. 37/38.

¹² Cf., e.g., A. P r e d ö h l , Außenwirtschaft (International economic relations), 2nd ed., Göttingen 1971, chapters 8 and 12

¹³ Ibid., p. 18/19. Cf. also the critical remarks in footnote 4

Arnt Spandau

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