

TRADE,
DEVELOPMENT
and
FOREIGN
DEBT

MICHAEL HUDSON

Volume I
International Trade



TRADE, DEVELOPMENT AND FOREIGN DEBT

A History of Theories
of Polarisation and Convergence
in the International Economy

VOLUME I
INTERNATIONAL TRADE

PLUTO  PRESS

First published 1992 by Pluto Press
345 Archway Road, London N6 5AA

Copyright © 1992 Michael Hudson

All rights reserved

British Library Cataloguing in Publication Data

Hudson, Michael

Trade, development and foreign debt.

1. Foreign trade. Theories

I. Title

382.104

ISBN 0-7453-0484-2 v.1 (cloth)

ISBN 0-7453-0489-3 v.1 (pbk)

ISBN 0-7453-0577-6 v. 2 (cloth)

ISBN 0-7453-0666-7 v. 2 (pbk)

Library of Congress Cataloging-in-Publication Data

Hudson, Michael, 1939-

Trade, development, and foreign debt : a history of theories of
polarisation and convergence in the international economy / Michael
Hudson.

p. cm.

Includes bibliographical references and index.

ISBN 0-7453-0484-2 (vol.1) (cloth) 0-7453-0489-3 (vol.1) (pbk)

ISBN 0-7453-0577-6 (vol.2) (cloth) 0-7453-0666-7 (vol.2) (pbk)

1. Protectionism – History. 2. International economic relations –
History. I. Title.

HF 1713.H83 1992

382 – dc20

90-19976

CIP

Printed in Finland by WSOY

Acknowledgements

Teaching international economics from a historical perspective during 1969–72 was only the starting point for this book. During the 1960s and 1970s Augustus M. Kelley and Garland Press enabled me to reprint many of the classics in international trade theory, and in many cases to publish introductions to them. In the late 1970s the United Nations Institute for Training and Research (UNITAR) provided an opportunity to develop a systems-analysis approach to juxtapose the reality of positive-feedback mechanisms in the world economy with the Chicago School's laissez-faire equilibrium theorizing. Joel Kurtzman, then of UNITAR and now with the *New York Times*, has been particularly helpful over the years.

In the 1970s I was able to recast my critique of the International Monetary Fund's intellectual pedigree in reports for Canada's Science Council, the Minister of State for Science and Technology, the Department of State and the Institute for Research in Public Policy. A preliminary emphasis on polarisation versus convergence mechanisms in these reports helped me focus the present book more along these lines.

Rik Davidson at the Toronto University Press provided support by obtaining Canadian government funding to publish this book in 1978. Although the university's economics faculty (free-market in commodity trade but not in ideas) censored its publication, the Press's reader, Tom Naylor, subsequently became a good friend and has made many valuable suggestions. Joe Hollander of M.E. Sharpe also made many good editorial suggestions, as did Jud Higgins and the late Al Eichner.

The earliest intellectual support for this book came from Gunnar Myrdal and, most of all, Terence McCarthy, in showing me that most of today's issues and their intellectual responses were anticipated, often eloquently, in past debates about the workings of the international economy. It was at their urging that I studied England's mercantilist/free-trade debate of 1750–75, the bullion debate following the Napoleonic Wars, and the long debate over the Corn Laws and other protectionist issues throughout the nineteenth century.

I am grateful to Lincoln Rathnam at Scudder Stevens & Clark for providing a forum within the business community for many of the ideas discussed in this book, and for helping to computerise the manuscript for publication.

It often happens that the universal belief of one age of mankind. . . becomes to a subsequent age so palpable an absurdity, that the only difficulty then is to imagine how such a thing can ever have appeared credible. . . It looks like one of the crude fancies of childhood, instantly corrected by a word from any grown person.

John Stuart Mill, *Principles of Political Economy* (1848),
preliminary remarks

Preface

This history of theories of international trade and foreign debt originated as the lectures for my graduate courses in international economics at the New School for Social Research during 1969–72. Teaching the subject was an exercise in irony: how was I to present a modern trade theory that ignores the widening international disparities in productivity and incomes, and a financial theory that endorses the IMF/Chicago School philosophy of economic austerity and chronic currency depreciation for debtor countries? Was it worthwhile wasting the time of students, many of them from third world countries, on theories which deny in principle the existence of structural payments deficits by assuming that all such problems are automatically self-curing?

Perhaps Robert Heilbroner, chairman of the Economics Department at the time, put it best: the task of economics departments was to turn out professionals. Therefore, the objective of the school's courses should be that when its graduates met other economists at social or business functions, they would have a common vocabulary and point of reference so as not to embarrass the school or themselves. A working familiarity with orthodox theories was to become their union card – and after all, it was to obtain jobs in the field that students registered for these courses.

This cut the Gordian knot of how to show the students that there was indeed practical relevance to the theories they were being asked to learn. But alas, however personally useful such knowledge might be in this respect, it was not a helpful body of theory for graduates to apply in practice.

The first question became one of whether there was any room to fit reality into the curriculum at all. Certainly there was no professional constraint for this to be done. It seems that once international economists get hired by universities or government agencies, they develop a remarkable tolerance for models describing a neat 'what if' world of trade and payments equilibrium.

My question was whether economic analysis had been so wrongheaded since its inception. Did the mercantilists and early free traders – men such as David Hume and Josiah Tucker, James Steuart, Adam Smith and the many critics of David Ricardo – really imagine a world in which economic conditions would converge rather than diverge? Did they define international investment and technological divergence among nations, as is done by modern theory? Did they really believe the simplistic purchasing-power parity theory of exchange rates?

Or have their theories been misrepresented by modern historians of economic thought, censored as being simply those of today's free-trade orthodoxy?

Even my brief initial survey showed that today's unreality of assumptions did not characterise past centuries. Before there was an economics discipline as such, trade and financial theory dealt dynamically with the monetary, demographic, political and technological dimensions of international economics. Yet most modern histories of the subject ignore – indeed, virtually expurgate – these contributions. They trivialise the works of David Hume and his contemporaries as being more simple-mindedly 'modern' than they actually were, for example, as in the price-specie flow adjustment mechanism. Since World War I international economics has gone so far as to define itself as a special subdiscipline assuming closed economies with no international migration of labour, no capital investment and no transfer problems resulting from unpayable debt overhead. These assumptions rule out considerations of what should be at the very centre of a realistic curriculum.

The usual histories of international thought are notorious for limiting their scope only to past anticipations of today's free-trade orthodoxy. If they deal with mercantilist writers at all, it is to harp on their most naive errors. The result is something like trying to reconstruct the writings of the early Christian Gnostics solely from the accusations of their persecutors and subsequent papal orthodoxy.

To help rectify this situation I undertook to write an alternative history of international trade and financial theories along more realistic and less anachronistic lines. Specifically, this book seeks to achieve four general objectives:

1. to trace the pedigree of theories demonstrating how the world economy is characterised by polarisation mechanisms. These mechanisms result both from market forces favouring the lead-nations and from the political diplomacy by which the governments of these nations have steered market forces over the past four hundred years;
2. to show why the world economy does not work in the way postulated by today's creditor-oriented laissez-faire orthodoxy, its so-called automatic adjustment mechanisms and financial austerity programmes;
3. to explain why countries submitting to this orthodoxy suffer intensifying poverty and chronic instability; and
4. to demonstrate what assumptions must be changed and, above all, what 'exogenous' factors (that is, those not acknowledged by the limited scope of today's orthodoxy) must be taken into account to create a more realistic theory.

By emphasising how the mercantilist, early 'free-trade imperialist' and protectionist perspectives (that is, pre-Ricardian and anti-Ricardian theory) achieved greater realism than today's orthodoxy, I describe not merely the enthronement of error – the subject to which most histories of economic thought restrict themselves – but also the development of more dynamic and lifelike theories of the world economy. In particular I focus on the migration of capital and skilled labour across national boundaries, and how capital-transfer burdens and widening cost differentials lead to dependency relationships which reinforce world economic polarisation.

In addition to surveying the history of international economics, this book lays the basis for a new theoretical perspective, which I call 'structuralism'. Its leading premises are the acknowledgement of

- i) the numerous absolute elements of national cost structures based on common international raw-materials and capital-goods prices. If all economies pay the same dollar-price for oil and other raw materials, capital equipment and services, how much effect does currency depreciation have on international goods-pricing?
- ii) the price inelastic (dependent) character of much trade. If countries need to import grain to eat, and oil to fuel their energy and heat their homes, how much 'correction' can be expected to result from price changes?
- iii) asymptotic limits in the form of minimum necessary import needs, scheduled debt service and other constraints that are not price responsive; and
- iv) the ability of active policymaking to change the quantity and quality of the various factors of production. If 'factor endowments' are the product of constructed policy, what effect does international diplomacy have on how the world economy works? And how does international investment and the migration of skilled and unskilled labour change matters?

In contrast to the price inelastic character of trade and payments assumed by laissez-faire theory, the reality is that currency depreciation for most economies impairs their balance of payments and reduces their long-term real income levels. By diverting domestic investment and output away from the home market to the export sector – the stated objective of stabilisation programmes – currency depreciation tends to depress the terms of trade, and hence the balance of trade even further. On the basis of these principles I find that structural limits exist for each country's balance-of-payments earning capacity, and hence the ability to service debts and otherwise subsist in today's world.

I conclude that IMF austerity programmes don't work. By curtailing national infrastructure spending, they impair rather than enhance productive powers.

What actually is called for is more infrastructure to lower economy-wide production and distribution costs. What also is needed is currency stabilisation to promote domestic saving to finance the direct investment which alone can raise international living standards and productivity.

Unfortunately, infrastructure spending and currency stabilisation are discouraged by short-run price theories that take productivity considerations for granted as being the result of allegedly natural endowments. These are supposed to be subject to diminishing returns and other unrealistic assumptions. By contrast, this book emphasises the history of theories as to how foreign trade may work to transform international labour and capital productivity under conditions of increasing returns, at least for successful economies. To take account of how production in all countries has become more capital-intensive, and also is being financed more than ever before with borrowed capital, the final section of this book explains the role of national financial structures in determining world competitive advantage. With such modern questions, however, we leave the realm of what early theorising had to offer. I therefore conclude this book with a summary of what is needed to reverse the narrowing scope of international economics so as to achieve a body of theory better able to deal with what has become today's dynamic and multilayered world economy.

Contents

Volume I

Acknowledgements	ix
Preface	xi
Introduction: The Political Context	1
Part I ORIGINS OF INTERNATIONAL ECONOMICS	
1. Early European Commercial Strategy: Its Moral and Political Assumptions	9
2. Imperial Origins of the World Division of Labour	29
3. The Monetary Impact	46
4. How Mercantilism Evolved into Laissez Faire	69
Part II THE CREATION AND DIVISION OF WORLD PRODUCT AND INCOME	
5. Comparative Costs and the Gains from Trade	103
6. Terms-of-Trade Analysis in its Historical Context	148
7. Technology and International Trade Theory	170
8. The Factor-Proportions Theory of Comparative Costs	190
9. Polarisation vs Convergence Tendencies	219
10. The Changing Role of Foreign Trade in Economic Development	238
11. The Narrowing Definition and Methodology of Trade Theory	260
Index	

Volume II

Part III THE IMPACT OF FOREIGN DEBT ON TRADE AND DEVELOPMENT

- | | |
|---|-----|
| 12. How Trade and Investment Patterns Reinforce Each Other | 289 |
| 13. Structuralist vs Monetarist Financial Analysis | 310 |
| 14. The Napoleonic Wars and England's Bullion Debate | 330 |
| 15. Debt Service and the Terms of Trade | 358 |
| 16. The German Reparations Debate and its Theory of Structural Limits | 385 |
| 17. Keynesian Income Approaches to the Balance of Payments | 412 |
| 18. How Monetarist Austerity Perpetuates Bankruptcy | 428 |

Part IV TOWARD THE FUTURE

- | | |
|---------------------------|-----|
| 19. The Lesson of History | 457 |
|---------------------------|-----|

Index

Introduction

The Political Context

Debates over economic doctrine are not merely academic matters; they concern the destiny of nations. As such, their inspiration is inherently ideological. Instead of starting with a disinterested attempt to describe how the world economy works, theorists seek *a priori* to defend the status quo or its transformation, dependency or autonomy, creditor or debtor interests, free trade or protectionism.

Given this setting, the task of economic models is not so much to describe what actually is happening as to discover what assumptions, scope and methodology are needed to produce a predetermined set of policy conclusions. Over the centuries international economic models have endorsed a division of world labour whose impact on development and the terms of trade has favoured either lead-nations or their raw-materials suppliers. But during the present century orthodox economics has represented almost exclusively the interests of the industrial creditor nations. Today's accepted body of theory accordingly is limited by its desire to reach creditor-oriented free-trade results – a starting point falsely presented as being its conclusion, which is cooked in advance.

The basic premise of modern orthodoxy is that the world economy works automatically to promote equality of incomes, if only governments refrain from intervening. From this idea follow the theory's premises and methodology, which limit the scope of analysis to rule out a discussion of government policy-making in any positive sense. For instance, to view trade and investment as being the result of differing natural endowments is to discourage the analysis of how national policy has transformed economic and social development and the character of world resources over the past few centuries. Orthodox theory further assumes that productivity and institutional structures such as land tenure systems are given, rather than being the proper subject of economic policy to transform. Rarely acknowledging the role of government policies, diplomatic coercion or debt service, *laissez-faire* theory mathematically demonstrates, as being seemingly natural, the existing trade and investment patterns between

relatively self-sufficient and politically active industrial creditor nations on the one hand, and increasingly dependent, diplomatically passive third world debtor countries on the other.

What is so remarkable is that despite the widening disparities in international incomes and productivity over the past two centuries, academic economists continue to speculate on the logical conditions necessary to produce income equality. Formulators of such models reason as if their carefully selected scope, methodology and set of assumptions were perfectly objective and the epitome of scientific method. Yet their underlying methodology is so limited that it assumes equal (or as modern jargon puts it, 'homogeneous') labour and capital productivity throughout the world, *for only on this assumption would international incomes become more equal through free trade and investment*. While governments in the industrial nations have acted to prevent such equilibrating tendencies by spurring their domestic productivity growth and technological innovation, laissez-faire models speculate on what might happen if all governments remained aloof from the international trade and investment processes. In sum, this approach endorses policies of international specialisation and dependency.

When such a body of theory continues to be applied despite the fact that its postulated effects are just the opposite from those visibly occurring, one must attribute its success to its politically apologetic service. It has in effect become an exercise in public relations. For instance, when this theory recommends that countries specialise in what they are 'best' at producing at any given moment in time, it advises them to ignore the long-term gains from protectionism designed to maximise *future* wealth and well-being. It also ignores the corrosive dependency effects of the monoculture syndrome – reliance on a few raw materials leading to dual economies throughout the world's southern hemisphere.

When this theory uses a set of definitions and tautologies to demonstrate that existing productivity differentials are what in fact make the Ricardian 'gains from trade' possible, it is making a political statement that protectionist moves to achieve self-dependency involve a wasteful loss of opportunity – the opportunity to live relatively well in the present, regardless of the future. Meanwhile, by presuming automatic tendencies to be at work within the world economy to promote equilibrium and indeed, parity, such theorising nurtures an unwarranted faith in economic processes that in fact intensify international disequilibrium and economic divergence. This is the central irony of modern international economics.

By emphasising pricing and distribution functions rather than production functions (which are taken for granted *a priori*), orthodox trade theory

ignores the extent to which production coefficients and technology can be altered – and the extent to which this in turn requires public infrastructure spending, and hence national policy.

So successful has this narrowing of scope become that even the United Nations Conference on Trade and Development (UNCTAD), against the interests of its own constituency, has viewed third world trade problems simply in terms of international pricing within the context of existing production and trade relations. Instead of urging third world countries to develop their agricultural self-sufficiency by shifting land, labour and capital from export production to domestic production, UNCTAD has urged industrial nations to support raw-materials prices for today's export monocultures so that the latter can continue to exchange their primary products and low-wage manufactures for essential food and high-technology imports, albeit under better commodity terms of trade (much to the benefit of the world minerals cartel as well as the international banking community). This suggests that the solution to low third world income levels and chronic payments deficits is merely to increase raw-materials export prices, not to change underlying production patterns by modernising agricultural and industrial structures. The result is a policy prescription which promises merely to finance the failure to diversify, not to broaden and upgrade the national economic base. The status quo is to be subsidised rather than transformed.

No wonder the new protectionism is so shallow compared to that of past centuries as applied by Britain, the United States, Germany and Japan. A more realistic theory based on the experience and economic success of these nations would acknowledge that international trade, investment, finance and diplomatic leverage are inextricably linked. It would describe how these industrial lead-nations have monopolised the gains from trade and parlayed them into an investment position that has consolidated their control over world resources. It would trace how international credit has been extended far in excess of debtors' realistic capacity to pay, keeping them on a tight debt leash. It would demonstrate how the attempt to transfer the requisite foreign exchange depresses debtors' terms of trade to the benefit of creditor-investor nations. Finally, it would acknowledge how the resulting 'market' tendencies are capped by a quite visible political hand: in order to receive World Bank, IMF and commercial bank credit and foreign aid, third world countries must pursue austerity programmes and relatively free-trade policies dictating even more intensified concentration on raw-materials exports, thereby subordinating their development chronically to serve that of the industrial nations.

One thing above all is clear: no invisible hand guides world market forces

to serve the interests of all trading policies symmetrically. At no time during the past two centuries has the world economy operated in the benign manner believed by today's laissez-faire proponents. Early free-traders were anything but benign, as indicated by Bernard Semmel's term for their theorising: 'free-trade imperialism'. The gains from modern industrial and agricultural technology have been concentrated in the industrial nations and converted into an international creditor position. Investment has been applied one-sidedly to the third world's export sectors, warping their domestic sectors into a monoculture syndrome from which they are today belatedly seeking to escape.

Despite the worldwide reaction against economic statism that has occurred in the 1980s, the consequence of today's world financial crisis probably will be a general reversion to economic statism in one form or another. Dissolution of Soviet economic planning principles and, with them, much academic Marxian economics may even have helped clear the way for a serious re-examination of effective versus ineffective government planning principles. For the great question today is, what specifically will be the character of future national planning in the face of the looming world financial and technological transformations of the 1990s.

A meaningful statism requires a broad perspective and scope capable of interrelating economic, financial, technological, ecological, demographic, international, military, social, political and cultural functions into an integrated overall view. For this reason alone a re-examination of mercantilist and protectionist theories of trade and development is justified, for they sought to develop just such a comprehensive world view.

In fact, the creation of a broad scope was precisely the task set for themselves by the founders of economic policy in Britain, continental Europe, the United States and Japan at the outset of their moves toward international power. Comprehensive protectionist theories underlay the policies followed by all of today's industrial nations during the formative period when they sought to catch up with and overtake the lead-nations of their day – the Netherlands and France in the seventeenth and eighteenth centuries, and Britain in the nineteenth century.

A renewal of development-oriented theorising may enable two approaches to international economics once again to be juxtaposed as they historically have been. On the one hand is the laissez-faire monetarist doctrine employed by the International Monetary Fund and World Bank, spiced with some Keynesian income theory but lacking any hint of Keynes's early writings on the transfer models problem. Price formation and income distribution are analysed by models that either take productive powers for

granted or assume them to equalise internationally over time. On the other hand is a production-oriented body of theory yet to be restated in modern terms, based on the perception that the mechanisms of today's market-oriented trade and finance (reinforced by the visible or invisible hand of governments) are responsible for widening disparities of international productive powers and incomes. Such models would be able to explain why physical productivity and balance-of-payments earning power have been retarded for less developed countries, pushing their international payments into structural deficit within a polarising world economy.

It is to pave the way for such a body of theory that I have written this book. I wrote it in the process of searching through the literature to see how economic theorists in earlier times have conceptualised the problem. This history of trade and development theory and the theory of capital transfers accordingly is about ideas and debates, not a comprehensive catalog of personalities. Rather than surveying every writer on international economics, I have chosen to present a history of the major theoretical concepts that have shaped international economics, since its inception in the mercantilist epoch. I focus above all on a common thread spanning over two and a half centuries of theorising: the question of whether the international economy, when left to 'free market' principles, tends to promote economic convergence or polarisation between lead-nations and latecomers.

In this endeavour I have not devoted space to the recent (post-1960) elaboration of trade theory. The admittedly abundant literature applies a rather limited number of concepts to a myriad of specific circumstances. This book emphasises general principles, not individual applications or subsequent restatements, except to trace the pedigree of today's monetarist orthodoxy back to the 'losing' Ricardian position in Britain's bullion debate following the Napoleonic Wars, and likewise the pedigree of free-trade orthodoxy to the Ricardian position in Britain's Corn Law debates.

This summary treatment of principles also has been dictated by the constraints of modern book length. It likewise happens to serve the original purpose of these lecture notes – to provide a syllabus for teaching theories of international trade and finance in their historical context. In view of the policy concerns that have inspired almost all economic theorising through the centuries, I think it is misleading to abstract theory from the political and ideological context of its times.

