The External Economy

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1. Introduction

Nations do not exist in isolation. Peoples have always roamed the globe in search of different opportunities. Nations principally trade to expand their consumption possibilities. In a world where we produce to consume, receiving goods and services is better in material terms than sending them elsewhere. Exports require the nation incur an opportunity cost by sending real resources (embodied in products or raw) to foreigners which could be used locally. Conversely, imports represent foreigners giving up their real resources (embodied in products or raw), which are then enjoyed by the importing nation. Accordingly, external deficits mean that a nation enjoys a higher material living standard.

Running external surpluses (exports greater than imports) effectively means that the nation is depriving its citizens of a higher material standard of living. They are working too hard, being paid too little, and/or under consuming. In that context, exports are a cost and imports are a benefit to a nation. People who have been conditioned to think that a nation that exports is in a stronger position than one that struggles to export goods and services, struggle to understand this fact. What we must remember is that production is not an end. The end is consumption.

Clearly, a nation that merely gives up material resources and gets nothing in return would be making itself poorer in material terms. And certainly, the history of colonial nations is riven with examples of resource plunder from colonial masters, which qualifies our statement that nations trade to expand consumption opportunities. The expansion happens but the beneficiaries may not be the nation’s residents.

That exports are a ‘cost’ suggests the motive to export. The ‘cost’ is incurred to generate benefits – to enhance the material prosperity of the nation. One reason that would lead a nation to relinquish access to its own real resources would be to get other real resources that it desires from other nations through trade. Which means the export cost is best considered as an investment in generating an increased capacity to import. However, this is not to say that a nation that runs an external deficit on goods and services will not encounter issues that will be challenging. We will explore these issues in this Chapter.

A nation’s external link with the rest of the world is not just confined to trade in goods and services. Financial flows also cross borders and these capital flows can be significant in shaping a nation’s prosperity as well as introducing instability in the value of its currency in world markets. It is thus important to consider how the two aspects of the external economy – trade and capital flows – interact.

Students in undergraduate economics programs encounter the topic of trade in two different ways. In macroeconomics courses, they learn the role of trade in the income-expenditure framework, where exports are a source of demand for the local economy and imports represent a loss of income to the rest of the world in search of goods and services produced elsewhere. They then integrate that knowledge into an understanding of the balance of payments, which records all international transactions between a nation and other nations and consider more advanced topics such as exchange rate determination.

In courses in international economics, they begin their journey typically by learning about the motivation for trade between nations – the so-called comparative advantage framework – where the free trade approach is first outlined. Comparative advantage was first conceived as an explanation for why nations trade by the English classical economist David Ricardo in 1817[[1]](#footnote-2). He argued that while a nation might be able to produce all goods more cheaply than any other, it was better devoting its resources to produce those goods for which it can produce relatively cheaper than another. In this case, Ricardo argued that exchanging goods between nations on this principle would make all nations better off.

While the idea of comparative advantage has been used to justify so-called ‘free trade’ arrangements between nations, and the ideology of the approach is often obscured to the student and they are, instead, confronted with a ‘law’ – the reality is that successful nations did not develop by following the principles of comparative advantage.

Initially, we introduce basic concepts that apply to any analysis of the external economy – the Balance of Payments, trade, capital flows, the exchange rate. Then we apply these concepts to developing an understanding of contemporary policy challenges such as industry policy, free versus fair trade agreements, currency instability, fiscal constraints arising from trade and capital controls.

2. The Balance of Payments

Transactions between nations involve both goods and services and financial flows. The financial transactions represent currency flows into and out of a nation and have significant implications for movements in the exchange rate and other macroeconomic aggregates, such as interest rates, the inflation rate and real GDP.

All transactions between a nation and the rest of the world are recorded in the Balance of Payments, which is a framework that is closely related to the national accounts.

The Balance of Payments and related accounts are compiled by national statistical agencies (such as the UK Office of National Statistics, the Australian Bureau of Statistics, the US Bureau of Economic Analysis) using an international standard set down in the International Monetary Fund’s Balance of Payments and International Investment Position Manual (BPM6)[[2]](#footnote-3), augmented by the System of National Accounts (SNA)[[3]](#footnote-4). While there are variations in terminology used by different nations, the principles are universal.

Like any accounting framework, the Balance of Payments is based on a double-entry debit and credit system of record. Credit entries consist of transactions where foreign residents make payments to local residents. Examples include exports of goods and services, income receivable from investments abroad, reductions in external assets, or increases in external liabilities. Debit entries consist of transactions where local residents have to make payments to foreign residents. Examples include imports of goods and services, income payable, increases in external assets, or a decrease in external liabilities.

The current account records all current transactions between a nation’s residents and non-residents in goods and services, primary income and secondary income. The balance of trade records “transactions in items that are outcomes of production activities”[[4]](#footnote-5) and reflect exchanges between the local economy and the rest of the world. Primary income includes payments of wages to a resident by a non-resident or income flows associated with ownership of financial assets (for example, dividend payments). These flows add to impact on national income. Secondary income flows do not and involve redistribution of income (for example, remittances, pension payments from abroad).

Economists often emphasise the current account because the transactions it records are of direct relevance to the determination of national income[[5]](#footnote-6). While the current account of a nation tends to focus on transactions with the rest of the world, which impact on the measurement of national output and income, the capital account records the financial side of these transactions. For a nation that exports more than they import, the net outflow of goods and services would be accompanied by accumulating financial claims against the rest of the world. This is because the demand for the nation’s currency to meet the payments necessary for the exports would exceed the supply of the currency to the foreign exchange market to facilitate the import expenditure.

How might this imbalance be resolved? One obvious solution would be for foreigners to issue liabilities to the domestic residents. This would lead to a net accumulation of foreign claims (assets) held by residents. This item would be recorded in the capital account as a debit because it enhances the capacity of non-residents to make transactions in the local economy. Another solution would be for non-residents to draw down local bank balances, which means that net liabilities to non-residents would be lower.

3. Exchange rate concepts

The exchange rate is the amount that one currency can buy of another currency in foreign exchange markets[[6]](#footnote-7). There are several different ways we can express that rate. The most obvious way is to define the **nominal exchange rate** (e), which is literally the number of units of one currency that can be purchased with one unit of another currency, the last currency being referred to as the reference currency. Consider the relationship between the Australian dollar ($A) and the British pound (£). How many Australian dollars are required to purchase one British pound? If the exchange rate is 2 then we know that it takes $A2 to buy £1. We could reverse the designated reference currency and express this exchange rate as $A1 buys £0.5. The latter quotation is the usual way we express the nominal exchange rate.

If the nominal exchange rate goes from £0.5 to £0.4 – a depreciation of the Australian dollar - then Australian residents will find all imported goods from Britain are more expensive *in Australian dollars*. Other things being equal, this should reduce the desire of Australian consumers for British goods (Australia’s imports). From the perspective of British residents, the depreciation in the Australian dollar, renders Australian exports cheaper in terms of sterling, and other things equal, will stimulate demand for those exports. The opposite is the case if the Australian dollar appreciates – say from £0.5 to £0.6.

The nominal exchange rate is determined in the foreign exchange (forex) markets, where the supply of and demand for currencies are linked to trade and capital flows between countries, and as well to relative interest rates and expected changes of interest rates between countries. The determination of exchange rates is exceedingly complex, and no theory or model that has been put forward has been capable of accurately predicting exchange rate movements. Some economists consider the transactions surrounding trade dominate while others consider cross-border transactions relating to financial assets are more significant in determining exchange rate movements.

What we can say is that when the demand for a currency is stronger than its supply, then it will appreciate and vice versa. When residents of a nation buy foreign goods (imports), buy foreign assets, or extend loans abroad, they need to purchase the relevant foreign currencies in which the transaction is denominated. To buy the currency they desire, they supply their currencies to the forex market in exchange. Similarly, when foreigners buy a nation’s goods and services (exports) and/or its financial assets they must purchase the local currency in the forex market by supplying their own currency in exchange. This represents the demand for the local currency.

The nominal exchange rate thus shifts to balance out the demand for and supply of a particular currency against other currencies. If, for example, there is an excess supply of a nation’s currency in forex markets, then, other things equal, the currency will depreciate and vice versa.

But the real world is subject to complex lags in responses to these price signals. Economists have complex frameworks (for example the Marshall-Lerner condition) to analyse the total impacts on a nation’s imports and exports that follow from exchange rate changes, which we do not consider here.

If a nation runs a trade deficit, increasing quantities of its currency are being accumulated by foreigners. Clearly, the foreigners have allowed the nation to run a trade deficit because they preferred to accumulate financial assets denominated in its currency. The alternative would have been to spend the currency they acquired through their exports to buy the nation’s imports (which would have created a bi-lateral trade balance). A trade deficit thus means that the foreigners are increasing their nominal savings in the deficit nation’s currency.

While trade flows are obviously important, the capital flows on the Capital Account can also drive movements in the exchange rate, given that financial transactions are many orders of magnitude greater - at least for the world’s major currencies.

The demand for a country’s financial assets will play a big role in determining exchange rates. For example, most of the demand for the Australian dollar in forex markets is not for the currency, *per se*, but rather for Australian dollar-denominated financial and real assets. Likewise, most of the global demand for the US dollar is not for purchases of US goods and services but rather for financial assets denominated in $US that can be held as earning assets in diversified portfolios.

Further, prices in asset markets are affected by interest rates. In foreign exchange markets, participants are concerned with *relative* interest rates that is, domestic interest rates relative to foreign interest rates, and *future* exchange rates. The decision to hold $US assets will thus be affected by current US interest rates relative to foreign interest rates, but also by expectations about the appreciation or depreciation of the $US relative to other currencies.

There are two rival theories concerning exchange rate determination in this regard. The mainstream approach - *purchasing power parity theorem* - focuses on trade in goods and services. The contention is that exchange rates move to equalise exchange rate-adjusted prices. In other words, whether one buys a McDonald’s Big Mac sold in the US or in Australia, one should pay the same price, adjusted for exchange rates. At this point, the *purchasing power* of the two currencies would be equal (at “parity”). Obviously, the price will deviate from this if there are differential transactions costs, including transportation costs. The important point is that this approach considers that the current account drives the exchange rate.

Keynes proposed an alternative approach - *interest rate parity theorem* - that focuses on asset markets[[7]](#footnote-8). The conjecture is that exchange rates are in equilibrium when expected returns to asset holders are equalised across exchange rates. In other words, if a portfolio holder is choosing between an Australian government bond and a US government bond, prices will tend to move to equalise total expected returns. The total return will include not only the expected interest rate paid but also the expected movement of the relative exchange rates. Purchasing power parity explanations are less capable of capturing exchange rate dynamics. By contrast, the interest rate parity theorem performs relatively well across currencies.

In terms of a nation’s international competitiveness, the nominal exchange rate is only part of the story in understanding the impact of the external sector on local economic activity. The **real exchange rate** is used to measure international competitiveness and it depends on two factors: (a) Movements in the nominal exchange rate, and (b) Relative inflation rates (domestic and foreign).

Take a situation where the nominal exchange rate is stable but domestic prices rise faster than the foreign price level. In this case, local goods are becoming relatively dearer than foreign goods. The opposite would happen if local prices were rising more slowly than foreign prices. These movements in relative prices (domestic and foreign) – are called the terms of trade – and influence a nation’s exports and imports.

If the real exchange rate rises, then a nation is deemed to be more competitive than before and this can arise if the nominal exchange rate increases, and/or, the world price rises by more than domestic prices. Conversely, a fall in the real exchange rate indicates reduced international competitiveness and will occur if the nominal exchange rate appreciates, and/or, if the domestic price level inflates faster than the foreign price level.

The solution to a declining international competitiveness is not straightforward. For example, is a declining real exchange rate driven by local prices rising faster than foreign prices, the result of, say, workers pushing wages up too quickly or firms seeking higher profit margins? During the GFC, mainstream economists advocated cutting wages for nations such as Greece to improve its external competitiveness, because there was no scope for adjusting its exchange rate once it entered the common currency. The problem though is that a wage cutting exercise not only reduces aggregate spending and pushes the nation further into recession, but also is likely to undermine productivity, which further damages its international competitiveness.

In that situation, overall business investment is likely to fall in response to the extended period of recession and wage cuts, which erodes future productivity growth. Thus, there is no guarantee that this sort of strategy will lead to a significant fall in unit labour costs. The research literature is replete with evidence that nations that pay high wages and offer workers secure employment deliver superior productivity outcomes, which yield improvements in a country’s international competitiveness.

4. The role of trade in output and income generation

In macroeconomics, students encounter the income-expenditure model early in their studies to ground their understanding of how total spending drives output, which creates incomes and employment. The income-expenditure approach is built from the basic macroeconomic rule that, subject to the existing productive capacity, total spending drives output and national income, which in turn, drives employment[[8]](#footnote-9).

Total expenditure in any period is the sum of domestic demand (household consumption, business investment and government spending) and net exports. The terminology - leakages and injections - is useful to understand how the output and income responds to changes in demand. Firms form expectations of future sales and hire productive inputs and scale production levels accordingly. Their hiring decisions generate national income (payments to inputs) and the spending that results determines how much of the production is realised in sales. If the firms overestimate spending, then the unsold inventories trigger production cuts and rising unemployment. Alternatively, if they underestimate spending, they increase output if they have productive capacity available. This dynamic process can come to rest – when expectations are realised, and total output (and national income) equals total spending. We call this an equilibrium or steady state, which just means, that at that point, there is no force present to compel firms to change production levels.

This equilibrium national output level (GDP) does not necessarily equate with the output level that would generate full employment. Keynes among others demonstrated that full employment was not guaranteed by the market system. Economies can become locked into situations where the economy is in ‘equilibrium’ but there is mass unemployment. This realisation motivates the role of government to use fiscal policy to act as a circuit breaker and ‘shock’ the economy into higher levels of output generation and employment by responding with a new injection of spending.

In relation to the external sector, net exports is the difference between an injection (exports) and a leakage (imports) from the income-expenditure stream. Expenditure on imported goods and services means that some of the national income produced in a period does not return to the local firms. We say that it has ‘leaked out’ of the domestic expenditure/income loop, which other things being equal, means that output will be lower than if import spending was lower. Exports, are generated by external factors and comprise an outside ‘injection’ into the local expenditure/income loop. Exports boost local production and income and can help offset the imports leakage.

While export spending boosts national income, we consider exports to be a cost in the sense that they deprive the domestic population of the use of the real resources that are used up in the production of the goods and services sold abroad. Even though import expenditure is a leakage from the expenditure system, we consider it to provide material benefits to the domestic economy by allowing households, firms and government to enjoy access to goods and services not otherwise available or available on competitive (qualitative and/or price) terms.

Import spending rises with national income and is also influenced, as we saw, by exchange rate movements and relative inflation rates between nations. Exports are similarly influenced by the real exchange rate as well as economic conditions in the foreign country. So as a nation’s economic growth increases, it will import more goods and services. As world growth increases, exports from a nation will typically rise.

5. Is a current account deficit a problem?

Modern Monetary Theory (MMT) demonstrates that spending by a currency-issuing government is only constrained by available real resources, which is contrary to the mainstream ‘sound finance’ assertion that growth is limited by the financial constraints that governments face. However, there is a body of literature that began with Hicks[[9]](#footnote-10) and was developed by Kaldor[[10]](#footnote-11) and Thirlwall[[11]](#footnote-12) that considers that the true constraint on a nation’s growth rate is the balance of payments. What does that mean? Mitchell[[12]](#footnote-13) considers this literature in some detail. Here we present a summary of the argument.

Kaldor[[13]](#footnote-14) developed a growth model where “the general level of output at any one time is limited by available resources, and not by effective demand” and thus characterised the constraint in terms of labour scarcity. In this sense, it is uncontroversial that if the economy is operating at full capacity, then no further real output is possible.

He later departed from that view, and, instead, postulated that the growth process was constrained by export demand that a region or nation experienced[[14]](#footnote-15). His argument relied on the rather curious assumption that exports revenue was the only source of exogenous expenditure. By assuming that all domestic expenditure was purely induced by an export shock, Kaldor could show that there was a unique growth rate which created a trade balance. In other words, once domestic income was stimulated by export demand, induced import expenditure would rise and once it was equal to exports, the growth constraint was encountered. All the action is thus on the current account, with exports defining the available foreign exchange resources. The long-run constraint is binding because he thought that if the nation tried to grow at a faster rate, then it would run out of the capacity to fund its imports.

Kaldor’s treatment of fiscal policy was at that time questionable. He assumed that government expenditure was limited by the endogenous taxation revenue it received. Kaldor[[15]](#footnote-16) also emphasised that using fiscal policy to increase “production and employment through a stimulus to domestic demand would ... increase imports relative to exports; this would have brought a downward pressure on sterling”. Thus, we have a very orthodox argument against discretionary fiscal interventions.

In early Keynesian growth theory[[16]](#footnote-17), investment that was considered to have a dual characteristic: (a) it added to immediate aggregate demand; and (b) added to future productive capacity, which meant that future aggregate demand had to be higher again to avoid unemployment. In Kaldor's trade-driven growth approach, it is exports that take on this dichotomous role because, in addition to adding to aggregate demand, they also increase the capacity of the nation to import because of the foreign exchange they bring to the nation.

The dual nature of exports in Kaldorian growth theory, spawned what has become known as the ‘balance-of-payments-constrained growth’ (BPCG) theory, which asserts that the long-run growth process is constrained by a nation’s exports, given the assumption that there must be a balance of trade[[17]](#footnote-18). The assertion requires several assumptions to hold, including - export spending is the sole autonomous demand component, the real exchange rate is stable and there is a balance of trade.

Further, the introduction of financial flows on the capital account negates the Thirlwall assumption that exports are required to pay for imported goods and services. In other words, a nation could record permanent trade deficits, without degrading its currency. In this case, the maximum BPCG output level would be below the possible output level. The question then is at what point do the net financial inflows stop. Some writers have suggested “that the propensity of … [net financial inflows] … to boost growth must be regarded as a strictly short-run result … [and] … cannot represent the long-run equilibrium growth rate”[[18]](#footnote-19). However, that conclusion remains purely an assertion. Nations such as Australia have recorded persistent current account deficits for decades while maintaining relative currency stability.

Interestingly, later in his career, Kaldor[[19]](#footnote-20) appeared to modify his position considerably “as he applies the model to the analysis of actual processes of growth in real economies”[[20]](#footnote-21). That shift appears to have been lost on many Post Keynesians, who consider the BPCG concept to be an eternal verity.

The debate can be distilled in the following way. First, there is a difference between the overall level of foreign debt held by the private sector that a nation can bear and the ability of the national government to maintain full employment with the resources that are available to it. If there are underutilised productive resources seeking work in a nation, the currency-issuing government can always bring them back into productive use. The BPCG theory asserts that if governments persist in running fiscal deficits to achieve full employment, then eventually international financial markets will attack the currency and cause a massive depreciation with accelerating inflation coming from the rising import prices feeding into the domestic price level. The evidence is scant. There appears to be no robust statistical relationship between national fiscal dynamics and the evolution of a nation’s exchange rate. It is also unlikely that import expenditure will rise dramatically because of the government supporting full employment, given most nations already have income support systems for the unemployed.

Second, an analogue of the BPCG approach is that the rise in the current account deficit (exports less than imports plus net invisibles) is interpreted as an excess of investment over saving. The claim is then that the only way a nation can counter that imbalance is through foreign investment (via an offsetting capital account surplus) which means that the net accumulation of foreign claims on the nation (via direct investment income, debt repayments or equity dividends) increases. This is the so-called ‘living beyond our means’ narrative and is the most popular derivative of the BPCG idea. The narrative also claims that current account deficits reduce potential growth because the increasing foreign ownership reduces profit retention and hence investment.

There are several issues. From a consumption perspective, it is undeniable that for an economy, imports represent a real benefit while exports are a real cost. Exports mean that the nation incurs an opportunity cost – the real resources embodied in the exports benefit the foreigners and locals are denied access to them. Conversely, imports represent foreigners giving the nation something real and beneficial that they could use themselves. In other words, the opportunity cost reversed. Thus, net imports means that a nation gets to enjoy a higher material living standard by consuming more goods and services than it produces for foreign consumption.

The real terms of trade for a nation are defined in terms of the relationship between exports and imports. A trade deficit is a sign that the real terms of trade are working in favour of the deficit nation.

Clearly, the motive that would lead a nation to relinquish access to its own real resources would be to get other real resources that it desires from other nations through trade. Thus, the export cost is best considered as an investment in generating an increased capacity to import beyond that allowed by net financial inflows on the capital account.

Recognising this, does not mean we should disregard a current account deficit. First, it is true that foreigners (surplus nations) build up financial claims in the currency of the deficit nation. If the government allowed, they might liquidate these claims purchasing real estate (for example, Russian and Chinese property acquisitions in London), which might undermine the prosperity of the local residents (for example, through housing affordability issues). But the nation state can legislate whatever restrictions they like in this regard and prevent foreigners using the local currency, obtained through trade surpluses, to purchase strategic assets.

Second, the foreigners might liquidate their local currency holdings in forex markets. The reason that nations can run external deficits is because foreigners are willing to exchange their exports for financial claims in the local currency. That preference could change at any time. Clearly, the deficit nation gains the terms of trade benefit while the preference holds. But if the preference changed suddenly, then the deficit nation may be exposed to rather harsh adjustment costs. That possibility should always be recognised. But major sell-offs by currency holders would expose the selling parties to exchange losses if a significant exchange rate depreciation resulted.

Third, if the local currency holdings end up in the hands of speculators, which implies the motivation is different from a trading entity, the nation state can always impose capital controls to protect its currency. I will come back to capital controls later.

Fourth, more problematic is that foreign interests may seek to use their financial clout to manipulate the political system and the public through media domination. However, strict campaign funding and media ownership rules can militate against these negative consequences.

Finally, some argue that persistent external deficits accelerate the process of deindustrialisation (loss of manufacturing capacity), which reduces opportunities for high-skilled, well-paid employment, damages productivity growth and innovation, and leaves the nation reliant on imported goods and services. There are often arguments made that a nation needs to protect local manufacturing to ensure self-reliance in the event of war. Which means that a government can always adopt a forward-thinking industry policy to expand domestic industry, spawn innovating research and development, upskill the workforce, build export capacity, etc, as long it has available real resources or can acquire them from abroad. An MMT understanding allows us to appreciate that there would be no financial impediment for a government building national industries, funding research and development, providing first-class universities and apprenticeship training and the rest. If a nation with its own currency slides into oblivion by closing its manufacturing sector, cutting career public sector jobs and relying on low-paid and precarious service sector jobs for employment creation, then that has little to do with running external deficits, and everything to do with political choices.

Further, there are other reasons for maintaining a manufacturing sector, which include maintaining infrastructure as part of a defence strategy and building self-sufficiency in essential goods and services (such as health care products).

The conclusion here is that the BPCG literature only posits a theoretical long-run constraint based on rather restrictive assumptions. Even Kaldor recognised that in the real world, the situation is more complex and nations can indeed grow faster than the theoretical limit denoted by Thirlwall’s law.

6. Speculative capital flows and capital controls

The balance of payments constraint literature feeds into the broader debates about whether a nation must appease the international investors or face a debilitating attack on their currency. The history of financial crises indicates that large-scale financial speculation can undermine a nation’s real economy relatively quickly if the government attempts to peg its currency to another or the economy has significant foreign-currency-denominated debt exposure (private or public). While the international community could agree that certain forms of speculative activity would be considered illegal, in lieu of that, the nation under attack must defend its own prosperity.

One such suggestion is to introduce capital controls, which limit the size and flexibility of international financial flows. Capital controls are policies that restrict the free movement of capital, either in terms of inflows or outflows.

There are broadly two types of capital controls used:

* Administrative or direct controls, which impose limits or bans on capital flows.
* Market-based controls, which impose extra costs on capital flows which reduce the incentives to shift funds across national borders.

A government might, for example, place limits on foreign exchange transactions, international bank transactions, or bank withdrawals. Restrictions on movements of precious metals such as gold might also be considered. The aim is to limit the scope of speculative flows (in or out) to manipulate the exchange rate and relieve the strain on the central bank’s foreign exchange reserves. Capital controls allow the central bank to run an autonomous monetary policy (freed from having to defend the currency parity) and the treasury to use fiscal policy to manage domestic demand in the interests of the nation.

The case for use of capital controls is strongest for two cases: countries that desire to manage their exchange rates, and nations pursuing a development strategy. As we have seen countries that do not float their exchange rates are subject to speculative attacks. While floating rates preserve the most domestic policy space and, at the same time, remove the incentive to speculate against the currency, some countries persist in either fixing their exchange rates, or in carefully managing them (sometimes within a narrow corridor). China is an example of such an exchange rate regime. In this case, the nation can guard against speculative attacks by imposing capital controls that make it difficult to exchange the currency. China has historically tightly managed the flow of capital.

A country that is pursuing a development strategy in the context of a floating exchange rate might face the prospect of strong currency appreciation. Foreigners sensing profitable opportunities in the nation might rush in with short-term investment strategies to make quick profits. However, rising exchange rates can work against the development strategy, as foreign currency prices of the nation’s output rise relative to world prices. The developing nation might protect its new industries by constraining short term capital flows to keep speculators from excessively appreciating the currency.

The case for use of capital controls by a rich, developed country on a floating exchange rate is generally weaker. However, in the absence of effective international regulation of financial practices, even such a country might need to protect itself from abusive practices by foreign financial institutions. There are notable examples in recent history.

In Europe, the short period of exchange rate stability reflected the use of capital controls, particularly by France and Italy. They prevented some of the speculative movements that would have normally destabilised the nations’ exchange rates. Italy relied on capital controls extensively and only started to withdraw them in 1988 once the Single European Act banned them[[21]](#footnote-22). The Single European Act of 1986 reflected Monetarist, ‘free market’ notions and stipulated that all capital controls were to be abolished by July 1, 1990. Exceptions were made for Ireland and Spain (December 31, 1992) and Greece and Portugal (December 31, 1995).

The abolition of controls eliminated one policy tool that governments had to maintain stability, and this became evident in 1992. Eichengreen and Wyplosz[[22]](#footnote-23), among others, recognised the bind that European governments were getting themselves into, when they coined the term “The Unstable EMS”. Eichengreen and Wyplosz[[23]](#footnote-24) also argued that the capital controls “protected central banks’ reserves against speculative attacks” by reducing the possibility of the exchange rate being driven below the agreed fluctuation bands (which would require central banks to sell foreign currency in return for its own). This allowed the central banks to “retain some policy autonomy”[[24]](#footnote-25), in the sense that they could pursue domestic objectives such as economic growth and low unemployment, which may have also meant that a particular nation’s inflation rate was higher than its competitors. The capital controls gave them this leverage. Once capital controls were eliminated, central banks became vulnerable, as they had to focus policy on defending the nominal exchange rate parities. And with the rising instability, this vulnerability became acute[[25]](#footnote-26).

More recent examples demonstrate, however, that capital controls can be effective. Malaysia imposed a range of controls on capital outflows during the 1997-99 Asian financial crisis, which “helped to stabilize the exchange rate”[[26]](#footnote-27). When the Czech and Slovak governments decided to abandon their short-lived monetary union in early 1993, cross-border currency movements were prohibited while new Slovak banknotes were issued. The old Czech banknotes were ‘stamped’ and were in use in Slovakia until August 1993. Capital controls were very effective in protecting the Slovak banking system. More recently, Iceland also imposed capital controls in 2008, which limited the extent of the depreciation of the currency.

While mainstream economists claim that the financial markets will always subvert capital controls, development economist Dani Rodrik[[27]](#footnote-28) adopts a more realistic assessment:

Even if true, evading the controls requires incurring additional costs to move funds in and out of a country – which is precisely what the controls aim to achieve. Otherwise, why would investors and speculators cry bloody murder whenever capital controls are mentioned as a possibility? If they really couldn’t care less, then they shouldn’t care at all.

In general, the balance of payments should not be an issue of concern for governments in their quest to maximise the well-being of their citizens. The reality is that all open economies are susceptible to balance of payments fluctuations. What is usually not mentioned is that these fluctuations were terminal during the fixed exchange rate system for external deficit countries because they meant the government had to permanently keep the domestic economy in a depressed state to keep the imports down so as not to run out of foreign reserves. For a flexible exchange rate economy, the exchange rate does the adjustment. There is no balance of payments constraint facing a nation in this regard.

There is also no robust evidence that nations that run continuous fiscal deficits create catastrophic exchange rate depreciation in flexible exchange rate countries. It is often overlooked that any spending growth, including private investment spending, will push up imports. For less developed nations, the necessary investment spending to promote growth is usually import intensive because most LDCs must import capital equipment. However, if that investment promotes domestic capacity then the nation can continually push against any notion that it is constrained by its external sector.

In the next section, we consider the case of a nation that must import all of its essentials to sustain life.

7. Trade and Developing Countries

A major point of difference between Post Keynesians (in the New Cambridge tradition) and MMT economists is that the latter argue that a currency-issuing government is not constrained in its capacity to generate full employment through appropriate fiscal policy settings.

Accordingly, such a government can always use its currency-issuing capacity to ensure that all available productive resources that are for sale in that currency, including all idle labour, can be productively engaged. Thus, a departure from full employment of labour is always a political choice. The capacity of a currency-issuing government, for example, to introduce a Job Guarantee, is not compromised by the external status of the nation. There is no financial constraint on such a government who desires to achieve that desirable policy goal.

While that might sound salutary, it somewhat evades a further question as to whether achieving this desirable goal moves a nation out of poverty. Facing no financial constraint in its own currency does not mean that a government will be able to avoid the external factors that can constrain the advancement of material prosperity for its citizens. For less-developed countries, a currency-issuing government faces different issues to that of an advanced nation, especially where essentials like food and energy must be imported. In the case of less-developed countries, specific problems cannot be easily overcome by just increasing fiscal deficits.

Being able to achieve full employment doesn’t mean the nation will escape material poverty. If a nation can only access limited quantities of real resources relative to its population, then no matter what capacities the government might have, that nation will, likely, remain materially poor. The ultimate constraint on material prosperity is the real resources a nation can command, which includes the skills of its people and its natural resource inventory.

Thus, even if the government productively deploys all the resources a nation has available, it will still be poor if its resource base is limited. If a nation has little that the world wants by way of its exports, and if that nation is dependent on imports for, say, food or energy, then the capacity of the currency-issuing government to alleviate poverty is limited. This is not a balance of payments constraint as it is normally considered. It is a real resource constraint arising from the unequal distribution of resources across geographic space.

Where imported food (or other essentials) dependence exists then the well-being of the citizens in that nation cannot be solved within its own borders, especially if its export potential is limited. Imposing austerity on these governments as is the standard conditionality requirements to gain access to IMF support is no solution. Typically, this undermines public infrastructure development in areas such as education and health and makes it harder for the nation to escape its poverty trap.

In these situations, the responsibility for resolving the real resource constraints that operate through the balance of payments should be shared by all nations. The multilateral institutions that were introduced in the Post World War 2 period to coordinate international aid – the IMF and the World Bank – have failed in their respective missions. They became agents for the ‘free market’ ideology and through their structural adjustment packages and related policies have made it harder for a nation to develop.

In this context, a new multilateral institution should be created to replace both the World Bank and the IMF, which is charged with the responsibility to ensure that these highly disadvantaged nations can access essential real resources such as food and not be priced out of international markets due to exchange rate fluctuations that arise from trade deficits[[28]](#footnote-29).

Other reforms are necessary. There must be international agreements to outlaw speculation by investment banks on food and other essential commodities. It makes no sense to use staple food commodities to create derivative financial assets, which rely on purchasers manipulating supply to influence world prices to maximise profits.

Relatedly, the only sustainable way to end the currency threats that weaker nations face from speculators, is for nation states to come together and legislate against speculative financial flows that have no necessary relationship with improving the operation of the real economy. In the absence of such international cooperation, nations should consider imposing capital controls where they can be beneficial bulwarks against the destructive forces of speculative financial capitalism (we considered the case for capital controls in Section 6).

Further, in some situations a case can be made to impose import controls on equity grounds where the export base is thin, and a nation is struggling to amass sufficient real resources to ‘feed and clothe’ its people. This has nothing to do with fears that speculators will damage the currency and create hyperinflation through import price acceleration. While imports are clearly a benefit and exports are clearly a cost, there are still equity implications involved in the mix of imports that a nation might enjoy.

Selective import controls targeting products that are typically consumed by the rich and that are not essential to general well-being can ensure that a nation with a limited export base can use its limited import potential to secure goods and services that meet the necessities of life.

Finally, a case can be made that there can be a global benefit arising if a nation restricts its own capacity to export. For example, it is better for coal rich nations to avoid pursuing a growth strategy based on coal exports, given the worsening environmental problems. In those cases, a single nation should not be punished for the pattern of geographic resource distribution and a global response is needed to make sure the damage to that nation’s export potential does not impair its ability to import and fight poverty.

8. Industry Policy and economic development

The problem facing all economies and especially less developed economies is to secure a stable industrial base. Nations that trade in industrial goods face less volatile international markets than nations that rely on primary commodity exports. The latter often face large swings in their terms of trade, which impacts on their exchange rates and makes it hard to build a viable manufacturing sector. This problem was initially referred to as the Dutch Disease in an Economist article in 1977.

In the immediate Post World War 2 period, governments used planned industrial strategies as part of their policy mix to help regions maintain employment growth, encourage private investment in productive activities, and aid in the forward planning of skill development through apprenticeships and the like. These strategies were considered an essential part of the capacity to achieve and sustain full employment in most nations and to build self-sufficiency via diversity in the industrial base.

Industry policy took many forms but generally included the following elements[[29]](#footnote-30):

* Fiscal stimulus to expand production and employment by maintaining adequate spending growth.
* Import controls and other tariff-style measures.
* Price controls – to stop firms exploiting the import controls and pushing higher margins.
* Compulsory planning agreements between government and multinational firms to align investment, production and employment decisions with national interest.
* Development of import-substitution strategies by government.
* Nationalisation of key firms.
* Public ownership of major banks to divert investment to advance public interest.
* Less restrictions on trade unions to advance the interests of their workers.
* Broadening of the Welfare State.
* Cuts in military spending.
* Policies to reduce wealth and income inequality.

The ‘infant industry’ argument justified state support for emerging industries, whereby sectors would be protected in order for them to build economies of scale that would allow them to be internationally competitive once the industry support was withdrawn. In the Post World War 2 era - the ‘Keynesian’ period of full employment and strong productivity growth – saw most nations using a mixed planning-market based system for allocating productive resources and the state was always central in setting out planning parameters, engaging in direct ownership of state enterprises, implementing comprehensive regulative frameworks and assuming responsibility as a significant employer. In terms of the major aggregates – employment, GDP and productivity growth, reduced inequality, improved scope and quality of public services (health, education, utilities, etc) - this system was very successful. Two approaches to industrialisation were taken: (a) export-oriented (for example, South Korea); and (b) import-substitution (for example, India), although in most cases, nations used both strategies. Irrespective of the approach, both involved considerable state planning and support.

The problem was that in some cases, the baby never grew up, which meant that these policies allowed corporations to profit behind ‘tariff walls’ and enter cosy agreements with unions to share the margins that the protectionist policies created. It was argued that protection reduced the incentive for innovation, which meant that the support had to be on-going and ultimately self-defeating as the nation fell further behind in terms of international competitiveness.

The dawning of the Monetarist era in the late 1960s, which generalised into what we now consider to be the neoliberal period, defined by the dominance of the ‘free market’ orthodoxy, brought a widespread opposition towards state intervention, particularly the use of industry policies.

The conduct of the IMF and World Bank from the 1970s onwards reflects this antagonism. In its Post-Bretton Woods incarnation (post 1971), the IMF was implacably opposed to industrial policy interventions by governments. Their position became the norm among mainstream economists. It bullied governments into abandoning planning frameworks, where policy initiatives would help domestic industries grow through public subsidies, tariffs, partnerships in R&D, etc. In particular, import-substitution industrial development strategies were particularly discouraged and declined as the IMF forced governments to deregulate, privatise, impose fiscal austerity and eschew any sense of ‘picking winners’.

The new emphasis was on export-bias with free flow of capital (in and out) with the requisite domination of foreign capital in local ownership. The corresponding outflows of resources and income flows to foreign owners were lauded as being the exemplar of development as health and education spending was cut and environmental degradation accelerated.

This antagonism also permeated domestic politics in many advanced nations. For example, as Britain struggled to cope with the damage caused by the OPEC oil crisis in the early 1970s, the British government Secretary for Industry, Tony Benn proposed an alternative industrial plan to revitalise British industry in 1975. It was rejected at the time by the Prime Minister Harold Wilson and the Chancellor Denis Healey, who had succumbed to the Monetarist logic and were intent on imposing fiscal austerity and pursuing a deregulation agenda. They used a lie - that the government had run out of money and would have to be bailed out by the IMF - to force their Monetarist ideology onto the British Labour Party. It was no surprise that many industries went to the wall as nations abandoned fiscal support to maintain full employment, deregulated labour and financial markets, and abandoned domestic protections for their industries. The IMF claimed that this shows industry policy focused on import-substitution can never work. But the culprit was not flawed industry policy. Rather, it was the withdrawal of all the accompanying support structures that made it work, but which ran counter to the neoliberal ideology of ‘free markets’.

However, the great industrial transformation stories in history were not the result of the sort of development strategies promoted by the IMF and the World Bank. For example, the state-motivated development of industry in South Korea (such as, The Heavy and Chemical Industrialisation (HCI) program), would never have occurred if self-regulating markets were prioritised. Other examples, include the watchmaking industry in Switzerland).

Ha-Joon Chang[[30]](#footnote-31) wrote in his masterful rejection of the neoliberal approach:

This neo-liberal establishment would have us believe that, during its miracle years between the 1960s and the 1980s, Korea pursued a neo-liberal economic development strategy.

The reality, however, was very different indeed. What Korea actually did during these decades was to nurture certain new industries, selected by the government in consultation with the private sector, through tariff protection, subsidies and other forms of government support (e.g., overseas marketing information services provided by the state export agency) until they ‘grew up’ enough to withstand international competition. The government owned all the banks, so it could direct the life blood of business—credit …

The Korean government also had absolute control over scarce foreign ex- change (violation of foreign exchange controls could be punished with the death penalty). When combined with a carefully designed list of priorities in the use of foreign exchange, it ensured that hard-earned foreign currencies were used for importing vital machinery and industrial inputs. The Korean government heavily controlled foreign investment as well, welcoming it with open arms in certain sectors while shutting it out completely in others, according to the evolving national development plan …

The popular impression of Korea as a free-trade economy was created by its export success. But export success does not require free trade, as Japan and China have also shown. Korean exports in the earlier period – things like simple garments and cheap electronics—were all means to earn the hard currencies needed to pay for the advanced technologies and expensive machines that were necessary for the new, more difficult industries, which were protected through tariffs and subsidies. At the same time, tariff protection and subsidies were not there to shield industries from international competition forever, but to give them the time to absorb new technologies and establish new organizational capabilities until they could compete in the world market.

The Korean economic miracle was the result of a clever and pragmatic mixture of market incentives and state direction.

As the evidence mounted that the neoliberal strategies were anti-development, even the IMF started to sing a different tune[[31]](#footnote-32). They now concede that industry policy interventions that were the basis of economic planning in the Keynesian era were highly successful and only stopped being so, in some cases, when fiscal austerity was imposed, and trade controls were abandoned in the 1970s.

It is worth reflecting on all the mistakes that were made in the 1970s and beyond that were justified by the faith in the ‘market’ to provide the optimal development environment. Would Tony Benn have been so easily dismissed in 1975 by the growing mainstream view that free markets were the way to go? History might have been very different if these ideologically motivated institutions had not advocated neoliberalism.

Cherif and Hasanov[[32]](#footnote-33) admitted that:

During the later period, 1980–2010, when import substitution policies were rolled back in most developing economies, the average growth rates of manufacturing production dropped significantly, and manufacturing stagnated in many economies.

The fact that the nations that chose a state-driven import-substitution approach to industrialisation grew strongly without an export-bias suggests these policies should be an important part of development strategies. The reason that growth was not sustained in many nations from the 1970s is because institutions such as the IMF and World Bank forced nations into abandoning policy support for the import-substitution strategies in return for currency support, not that such strategies failed.

Significantly, nations that pursue import-substitution strategies and increase their self-reliance are also better placed to avoid the damage from fluctuations driven by currency speculation.

9. Free and fair-trade agreements

The discussion of industry policy overlaps with the debate about free versus fair trade. Like many aspects of mainstream economic theory – ‘free trade’ – initially sounds intuitively reasonable, but the gloss quickly fades once you understand the basis of the theory and how it derives its seemingly ideal results. In practice, the textbook ‘model’ is never attainable and so what goes for ‘free trade’ is really a stacked deck of cards that has increasingly allowed large financial capital interests to exploit workers, consumers and undermine the democratic status of elected governments.

Even within the mainstream approach the terrain has moved. The old perfectly competitive ‘models’ of free trade go back to the notion of comparative advantage, which was introduced by Classical economist David Ricardo[[33]](#footnote-34), and, later embodied in the Heckscher-Ohlin theorem[[34]](#footnote-35). These ideas were used to disabuse notions of government intervention in dealing with the external economy.

The idea of comparative advantage is that nations would enjoy gains from trade if they specialised in products that they can produce at the lowest relative cost even if one nation enjoyed an absolute cost advantage in the products. By trading, prices are driven down in the higher cost nation (without the comparative advantage in that particular good) because the export inflow increases the supply of goods. Similarly, the diversion of production into export markets rather than for domestic sales reduces supply in the home market and pushes up prices. The export flows stop when the prices are equalised across countries for each good.

It is argued that trade forces specialisation and drives out higher cost operators as productive resources are assumed to move costlessly into the production specialisation while full employment is sustained. Free trade is thus claimed to increase productive efficiency, because in each country, the respective labour forces, who are always fully employed, now produce more goods in total than before at the lowest possible cost. Further, by allowing these competitive forces to work, free trade improves the welfare of citizens in both countries, who gain access to more consumption possibilities at the lowest possible price.

The problem with the theory is that the assumptions required to generate the result that free trade is optimal never apply in the real world, including: (a) there is no unemployment and productive resources (capital and labour) are perfectly mobile between sectors and countries; (b) there is no market power to influence prices; and (c) all countries have identical production technology.

Wassily Leontief’s[[35]](#footnote-36) findings proved fatal for the comparative advantage model. His Leontief Paradox showed that the US, which was the nation with the most capital, was exporting goods and services that were more labour-intensive than capital-intensive, a major violation of the predictions of the Heckscher-Ohlin model. Further, the US imported more capital-intensive goods than it exported. Comparative advantage could not explain those facts. In the 1980s, the emergence of ‘new trade theory’ provided further argument to reject the Heckscher-Ohlin approach[[36]](#footnote-37).

Essentially, by demonstrating the underlying assumptions were invalid, these developments meant that economists could no longer argue that the results of the free-trade models held. Any further claims that free trade was optimal were purely advancing vested interests and supporting ideology. New trade theory showed that government trade regulations (for example, export subsidies and/or import controls) can advance national well-being.

The ideology of advancing corporate interests at the expense of other aspirations drives the free trade mantra. The reality is that the ‘free traders’ do not actually believe in the textbook concept of a free market that they advance. If such a state existed, then firms would have zero market power and they would only be able to earn so-called ‘normal profits’, which reflect opportunity cost.

No modern corporate leader aims to achieve that state. At a minimum, they aim to manipulate the ‘market’ they trade into to influence prices they can get and are required to pay for inputs and end up with as big a margin on total costs as they can achieve. They aim to create a unique product and drive competitors out of business as quickly as they can. If they can take over a competitor and increase their market share, they will. They seek to manipulate consumers into believing their product is best through advertising, which uses psychological tools that go well beyond the textbook idea that such interaction with the ‘market’ is just to provide ‘information’.

Robert Reich[[37]](#footnote-38) captured this cant eloquently:

Many of the most vocal proponents of the ‘free market’ – including executives of large corporations and their ubiquitous lawyers and lobbyists, denizons of Wall Street and their political lackeys, and numerous millionaires and billionaires – have for many years been actively reorganizing the market for their own benefit and would prefer these issues not be examined.

A market – any market – requires that government make and enforce the rules of the game. In most modern democracies, such rules emanate from legislatures, administrative agencies, and courts. Government doesn’t ‘intrude’ on the ‘free market’. It creates the market. It is little wonder why the corporate power brokers – their lawyers and lobbyists – vehemently pursue governments to agree to pro-corporation clauses in these so-called ‘free market’ agreements’. They know that without government support and agreement to tilt the playing field towards them and away from workers and consumers they will be forced into more equitable sharing of the national income produced in each nation.

While progressive political forces have convinced themselves that globalisation has rendered the state powerless in the face of global capital, the neoliberals worked out long ago that they had to work within the legislative environment established in each nation they wish to operate within. They sought to reconfigure the state to advance their own interests[[38]](#footnote-39). If the state was powerless, why do corporations spend billions lobbying governments to legislate in their favour?

The corporations don’t seek to play by the rules. They are continually seeking to change the rules to advance their own interests, irrespective of the impact on other stakeholders (workers, consumers, local communities etc).

We always need to remind ourselves that[[39]](#footnote-40):

It is no accident that those with disproportionate influence over these rules, who are the largest beneficiaries of how the rules have been designed and adapted, are also among the most vehement supporters of the ‘free market’ and also the most ardent advocates of the relative superiority of the market over government. But the debate itself also serves their goal of distracting the public from the underlying realities of how the rules are generated and changed, their own power over this process, and the extent to which they gain from the results. In other words, not only do these ‘free market’ advocates want the public to agree with them about the superiority of the market but also about the central importance of this interminable debate.

In discussions about ‘free trade’ versus ‘fair trade’, the misnomer of free markets must always condition the debate.

There are now a plethora of ‘free trade’ agreements and national leaders make grandiose claims to their citizens about the advantages that will flow to them. One of the problems with these agreements is that they are typically shrouded in secrecy, with governments pleading ‘commercial-in-confidence’ as their reason for preventing a full public debate on the proposed terms and conditions.

But we know that these agreements typically give corporations priority over a state and the citizens that the state represents. A controversial aspect of these agreements which strengthen these biases are the so-called **Investor State Disputes Settlement (ISDS)** clauses, which set up mechanisms through which international corporations can take out legal action against elected governments if they believe a particular piece of legislation or a regulation undermines their opportunities for profit. It is that crude. Profit becomes prioritised over the independence of a legislature and the latter cannot compromise the former. Under these clauses, ‘supra-national tribunals’ which are outside any nation’s judicial system, but which governments are bound to obey, are given power to adjudicate. The notion of accountability disappears.

These tribunals can declare a law enacted by a democratically elected government to be illegal and impose fines on the state for breaches. There have already been some astounding decisions in these ISDS under other agreements, which have denied governments the right to introduce policies regarding environmental protection (for example, toxic waste safeguards, forestry management processes, etc) (see UNCTAD, Investment Policy Hub).

A notable case relates to the lawsuit pursuit against the Australian government for introducing plain packaging with health warnings by an international tobacco company. The company claimed the health measures undermined its profitability. In its 2013-14 Trade and Assistance Review, the Australian Productivity Commission, which is a pro-market agency of the government, noted that[[40]](#footnote-41):

The Australian Government continued defence of its tobacco plain packaging laws in a case brought by Philip Morris Asia in the Permanent Court of Arbitration and a number of countries in the WTO dispute settlement body. This case highlights the potential (and un-provisioned) contingent liability of Investor State Dispute Settlement (ISDS) provisions in trade and investment agreements that confer procedural rights to foreign investors not available to domestic residents. The final outcome of the case is not expected to be known for some time. The ongoing costs to Australian taxpayers of funding the preparation and defence of the tobacco plain packaging legislation, and the ultimate ruling, are unknown, unfunded and likely to be substantial.

In other words, international corporations have more rights than residents. In this case, the Australian government won the case in December 2015. Later, we learned that the court costs, of which the tobacco company was forced to pay half, summed to more than $A24 million[[41]](#footnote-42).

There is a proliferation of these cases now attacking legislation that seeks to improve health and environmental outcomes. Only advanced nations with sufficient financial resources can defend their national sovereignty in this respect from the demands of global capital. These mechanisms in the ‘free trade’ agreements are designed to further skew the distribution of income and wealth to the top end of the distributions and to further neuter the capacity of governments to act independently according to elected mandates. They line up with fiscal rules, independent fiscal commissions, and the like as key vehicles to suppress our freedoms and choice of legislative environment in which we live.

Investor State Dispute Mechanisms are attacks on democracy. A nation state is defined by its legislature and that institutions sets the legal framework in which all activity within the sovereign borders engages. Corporations have rights under that framework as do citizens. But the assumption is that the legislative framework should reflect the goals of national well-being. There is never a case that a corporation should have institutional structures available to it to usurp the checks and balances built into national legislation.

A further problem in the way ‘free trade’ agreements have evolved relates to the way different nations can exploit the World Trade Organisation (WTO) rules. There has been an almost dichotomised development process among rich and poor nations, which goes back to the colonial era. The poorer nations (typically under colonial rule) had ‘free trade’ forced upon them with concomitantly poor outcomes, while the colonial powers adopted protectionist positions[[42]](#footnote-43).

Further, while tariffs have come down under successive rounds under the GATT and then the WTO, the global trading terrain has been anything but level. First, rich nations such as the US still maintain a complex array of tariffs on goods attempting to enter their borders. Japan, for example, maintains a highly protectionist stance with respect to its primary products (particularly against rice imports). These cases are generalised across most nations.

Second, the WTO maintains its view that low-wage countries attract capital because of their comparative advantage and it is this that leads to development. The evidence is not supportive of that belief[[43]](#footnote-44). The large capital interests resist any inclusion of labour standards in these ‘free trade’ agreements because they know they would undermine their ‘race-to-the-bottom’ strategy of profit capture.

Further, with organisations such as the World Bank and the IMF pushing export-led growth strategies for poorer nations, ‘corporate farming’ has become common. The environmental damage has been vast.

**T**he problem is complex. The aim of economic development is to reduce (and eliminate) poverty but within an environmentally sustainable frame. However, poverty itself, can undermine environmental sustainability. For example, to meet the demands of the World Bank to pay back debts sustainable agricultural practices have been replaced by export-led farming and widescale deforestation in many nations (for example, Nepal).

The IMF and the World Bank have pushed massive levels of debt onto less developed nations in the name of export-led growth, which is a partner to the neo-liberal ‘free trade’ narrative. They have also forced these nations to slash public services, privatise public assets and engage in extensive deregulation (particularly in capital flows). For example, in the 1980s, the African nation of Mali was placed under IMF and World Bank structural adjustment programs where poverty and hardship was deliberately exacerbated by privatisation, cuts to government employment and wages, and decimation of its public education system. IMF austerity was at the forefront of years of political instability and eventually, once the IMF had a government that would do their bidding without asking questions, it was declared a model nation by the Washington organisation. Foreign investment returned to boost the cotton industry but most of the returns courtesy of the IMF privatisation policies go to foreigners and living standards remain low for the locals. More than 50 per cent of people in Mali are poor. There are gross violations of human rights and a trend over the last decades has been for people to abandon their children in the poverty-entrenched cities because they cannot care for them[[44]](#footnote-45).

The example of Mali is not isolated. It is the norm when the IMF and the World Bank is involved. The 2010 conflict in India involving the proposal to build a coal-fired power plant in Sompeta, which would have destroyed the local sustainable fishing and farming industry is another example. The plant would have taken over valuable wetlands that is at the heart of community sustainability[[45]](#footnote-46). The OK Tedi disaster is another example of how multinational corporations, who profit from extracting resources from less developed nations, largely evade proper scrutiny of the environmental damage they create and the disruption this damage causes local communities.

It is also clear that the WTO has no coherent rules that restrict imports from nations that engage in poor environmental practices. They claim that[[46]](#footnote-47):

… no specific agreement dealing with the environment. However, the WTO agreements confirm governments’ right to protect the environment, provided certain conditions are met, and a number of them include provisions dealing with environmental concerns.

The WTO responds to calls for trade restrictions if environmental damage is likely to result from production by claiming that[[47]](#footnote-48):

… measures designed to meet these objectives could hinder exports. And they agree that sustainable development depends on improved market access for developing countries’ products.

They also state that “environmental standards applied by some countries could be inappropriate”, meaning that a nation does not have the right, under WTO thinking, to determine its own standards.

They have also warned against what they call ‘green protectionism’[[48]](#footnote-49). They adopt the standard mainstream economics position that the solution to pollution and environmental damage is to create more growth (and damage) to generate the resources necessary to combat the damage. This view is, in part, driven by the erroneous view that the national governments are financially constrained and cannot deal with the climate change issues without raising extra tax revenue from faster economic growth.

10. Fair Trade principles

When we say that exports are a cost and imports are a benefit, this is referring to the opportunity cost principle adopted under a strict, other things being equal assumption. In a material sense, with consumption as the end goal, we all typically benefit from trade, if and only if, it doesn’t violate the democratic choices we make and express through national government policies in areas such as:

* Working conditions – wages and conditions, occupational safety, etc.
* Rights to association and right to strike – formation of trade unions etc.
* Consumer protection – safety, ethical standards, quality of product or service etc.
* Environmental standards.

These criteria define what we call ‘fair trade’ and are in contradistinction to the type of trading arrangements embodied in so-called ‘free trade’ agreements.

Complexity arises when we try to achieve a cultural intersection as to how to define fairness in these areas. For example, the economies that avoided the plunge into high unemployment in the 1970s maintained what Paul Ormerod[[49]](#footnote-50) described as a “sector of the economy which effectively functions as an employer of last resort, which absorbs the shocks which occur from time to time, and more generally makes employment available to the less skilled, the less qualified”. Ormerod acknowledged that employment of this type may not satisfy narrow neoclassical efficiency benchmarks, but notes that societies with a high degree of social cohesion have been willing to broaden their concept of ‘costs’ and ‘benefits’ of resource usage to ensure everyone has access to paid employment opportunities. He argued that countries like Japan, Austria, Norway, and Switzerland were able to maintain this capacity because each exhibited “…a high degree of shared social values, of what may be termed social cohesion, a characteristic of almost all societies in which unemployment has remained low for long periods of time”[[50]](#footnote-51). In other words, a sense of fairness (equity) was sustained by collective will to ensure political choices were made to ensure adequate levels of employment. Conversely, governments in nations such as Australia or the US, have been less willing to ensure employment levels are sustained in the face of drops in economic activity.

Fair trade arrangements must therefore establish relevant labour and environmental standards to regulate trade. The WTO has had a poor record in this regard. Free trade agreements are notoriously weak on dealing with these issues. While it is recognised that nations in different periods of development will have different productive methods, working standards that are acceptable across cultures can be devised. However, within these differences, some standards remain common – the right to association, the right to adequate rest and breaks, the right to holidays, the right to fair pay, the right to strike.

While the details need to be worked out, the general principle is clear – trade should not be allowed if it violates the principles listed above.

This principle also qualifies, to some extent the essential insight that in a materialistic sense of well-being, imports provide benefits to a nation (goods and services otherwise unattainable), while exports are a cost (real resources are sacrificed and used by foreigners rather than the nation). Adopting the view that imports are beneficial doesn’t undermine our critique of ‘free trade’. Indeed, it strengthens it.

Some commentators might think that this starting point then militates against the advocacy for such things as import controls. The answer is that even though, in general, exports are a cost and imports are a benefit, the framework in which we make those assessments is multi-dimensional and extends the concept of material progress in ways that mainstream economics typically ignores.

For example, a commercial transaction that is only considered in terms of the use value that the consumer receives may involve massive damage to the producing community. Thus, while an imported good or service might be seen in narrow terms to be a ‘good’ for the consumer, once we broaden our assessment of the costs and benefits of the overall chain of production and consumption a more nuanced view will emerge.

By adopting principles that allow the actual costs, including damage to the environment, destruction of local sustainable industry, damage to human dignity of unfair work practices etc, the benefits of the import to a consumer will pale into insignificance relative to the costs of the producers. In those cases, import controls may be justified to limit the damage to the less developed nation, despite the material benefits to the more developed nation being obvious.

Further, there is a compositional aspect to the exports are a cost and imports are a benefit classification. In the case of primary commodity exporting nations such as Australia, the costs involved in mining its vast stores of iron ore maybe low, given the alternative use of the resource within Australia is limited.

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1. (Ricardo, 1817) [↑](#footnote-ref-2)
2. (IMF, 2011) [↑](#footnote-ref-3)
3. (United Nations Statistical Commission, 2009) [↑](#footnote-ref-4)
4. (IMF, 2011: 149) [↑](#footnote-ref-5)
5. See Section 4 [↑](#footnote-ref-6)
6. A more detailed treatment of this section can be found in (Mitchell *et al.*, 2019) [↑](#footnote-ref-7)
7. (Keynes, 1923) [↑](#footnote-ref-8)
8. See (Mitchell *et al.*, 2019) for more detail [↑](#footnote-ref-9)
9. (Hicks, 1950) [↑](#footnote-ref-10)
10. (Kaldor, 1957, 1970, 1971, 1978, 1989) [↑](#footnote-ref-11)
11. (Thirwall, 1979) [↑](#footnote-ref-12)
12. (Mitchell, 2022) [↑](#footnote-ref-13)
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14. (Kaldor, 1970, 1978) [↑](#footnote-ref-15)
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16. (Harrod, 1939) [↑](#footnote-ref-17)
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18. (Setterfield, 2011:408) [↑](#footnote-ref-19)
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20. (Palumbo, 2009: 363) [↑](#footnote-ref-21)
21. (Giavazzi and Giovannini, 1989; Eichengreen and Wyplosz, 1993) [↑](#footnote-ref-22)
22. (Eichengreen and Wyplosz, 1993) [↑](#footnote-ref-23)
23. (Eichengreen and Wyplosz, 1993: 57) [↑](#footnote-ref-24)
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25. For a detailed account see (Mitchell, 2015) [↑](#footnote-ref-26)
26. (Eichengreen, 2010: 24) [↑](#footnote-ref-27)
27. (Rodrik, 2010) [↑](#footnote-ref-28)
28. See (Mitchell and Fazi, 2017) for a more detailed development of this idea [↑](#footnote-ref-29)
29. (Rowthorn, 1981: 4-10) [↑](#footnote-ref-30)
30. (Chang, 2007: xx-xxi) [↑](#footnote-ref-31)
31. See (Cherif and Hasanov, 2019) [↑](#footnote-ref-32)
32. (Cherif and Hasanov, 2019: 52) [↑](#footnote-ref-33)
33. (Ricardo, 1817) [↑](#footnote-ref-34)
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37. (Reich, 2015: xiii) [↑](#footnote-ref-38)
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42. (Chang, 2007; Pigaud and Samba Sylla, 2020) [↑](#footnote-ref-43)
43. See (Chang, 2007) for case studies [↑](#footnote-ref-44)
44. (Bello and Cunningham, 1994) [↑](#footnote-ref-45)
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47. (WTO, 2022a) [↑](#footnote-ref-48)
48. (WTO, 2022b) [↑](#footnote-ref-49)
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