

# Thinking About Free Trade: The Role of Ideas in Shaping Trade Regimes

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EMMA BELL-SCOLLAN, JAN 11 2013

Throughout the 19<sup>th</sup> century, the existing European economic system of Mercantilism broke down and was replaced by a liberal economic structure. This system was distinct from the one it had preceded because of its adoption of free trade, a practice in direct contradiction to Mercantilist policies. Although this initial free trade regime was not long lasting, it was reestablished more permanently more than half a century later in the post-War period, with the General Agreement on Tariffs and Trade (GATT). Rooted in the principles of economic liberalism outlined by Adam Smith and David Ricardo, these regimes both acknowledged the benefits of comparative advantage and specialization, and as such, promoted free trade on the international level. However, they differed fundamentally in their treatment of the role of government intervention on the domestic level. This difference can be aptly explained when analyzed within a Constructivist framework, which demonstrates the causal relationship between a particular set of beliefs, shaped by experiences, and the establishment of a specific regime. In relation to the two trade regimes, it was the experience of the failure of liberal economics during the Depression that fostered the widespread belief that market systems could not satisfy the social needs of the people, and thus had to be paired with government intervention domestically. This belief shaped the GATT in a different direction from the initial trade regime of the 19<sup>th</sup> century.

This paper intends to explain how and why the trade regime of the eighteenth century differed from that of the post-War period. More specifically, it addresses that while they were constructed in ways that promoted very different domestic policies, they both understood the inherent social benefits of specialization through international trade. In order to accomplish this, it is first necessary to understand the basis of Constructivist theory. In his overview of Constructivism, Mark Brawley outlines the three core assumptions. First, he notes that interests and preferences are socially constructed, and as such, they are malleable.[1] Second, these interests and preferences are shaped by ideas. Finally, he explains that rationality is always contextual. These assumptions lay in contrast to Realist assertions by highlighting the influential role that ideas play on the structure of the international system.[2] Alexander Wendt elaborates on this definition of Constructivism. He notes that institutions or regimes are composed of "...a relatively stable set or 'structure' of identities and interest," which are "...often codified in formal rules or norms." [3] Together, Wendt and Brawley outline a causal relationship in which ideas shape the interests and preferences that form the structure of regimes. As such, the Constructivist approach highlights that it was an ideational change that was at the root of the domestic level differences between the pre-War trade regime and the GATT.

Adam Smith wrote *The Wealth of Nations* in 1790 amidst the decline of the Mercantilist system in Europe. Amongst many other things, he outlined the benefits of the division of labor, noting, "...the greatest improvements in the productive powers of labor...have been the effects of the division of labor." [4] Soon after, David Ricardo elaborated on this notion. Applying this concept on an international scale, he outlined how in a free-trade system, each country will naturally devote its resources to the production of goods in a manner that is most beneficial to each nation. [5] In other words, they will produce the goods that are the cheapest for them, thus maximizing their natural comparative advantage in production. Ricardo further states that this "...pursuit of individual [state's] advantage is...connected with the universal good of the whole." [6] These ideas of nation-wide specialization and trade-based comparative advantage form the foundation of economic liberal theory, and as such account for the regime similarities between trade in the post-War period and its precursor in the 19<sup>th</sup> century.

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In his account of European economic transformation, Karl Polanyi describes how in the mid-1800's, the theories of economic liberalism – as outlined by both Smith and Ricardo – burst forth into the public conscience with “a crusading passion.”[7] Initially constrained to the field of academic interest, Polanyi notes how these ideas were soon solidified into policies surrounding both trade and currency.[8] In other words, he is highlighting the influence that the broad reaching *laissez-fair* ideology had on the establishment of economic regimes. This can be proven by examining the specific nature of the trade regimes that emerged in both the 19<sup>th</sup> century and the post-War world.

As noted above, Ricardo posits that the process of state-specialization will occur naturally, and that all states involved will feel the benefits of such actions. In line with Ricardo's ideas, the movement from a closed to an open trade system was not accomplished through the coordination of an explicit regime, but rather occurred naturally through the unilateral policy actions of states across Europe and the Americas.[9] In his article, C. P. Kindleberger explains how the initial industrial successes of Great Britain and France legitimized liberal economic ideology, thus providing the impetus for countries like Switzerland, the Netherlands, Spain and Germany to each take policy action towards lowering tariffs and breaking down trade barriers.[10] Furthermore, the dominance of **inter-sectoral** and inter-continental trade between capital deficit and capital rich states proves that Ricardo's theory of comparative advantage was a driving force in the establishment of the pre-War free trade regime.[11]

The free trade system that emerged after the Second World War, institutionalized through the GATT, did not represent a total ideological break from its 19<sup>th</sup> century predecessor. As was the case with the regime of the 19<sup>th</sup> century, the economic theories of Smith and Ricardo lay at its foundation. Speaking from a Constructivist perspective, Wendt outlines the causal links between ideas, interests and regime structure. This relationship is clear when examining the regime structure of the GATT in terms of its role in shaping a state's international trade policies. In their article, Bagwell and Staiger establish the key principles of the GATT: reciprocity and non-discrimination between trading partners.[12] Tariffs in the post-War period dropped by 40% as a result of the policy implications of these principles.[13] Similarly, John Ruggie notes how the GATT promoted a form of comparative advantage in order to maximize the gains from trade. [14] Furthermore, it provided dispute settlement mechanisms and multilateral surveillance to enforce fair participation. Thus, the GATT worked to establish a free-trade system externally, in which inter-state trade was – to a certain extent – based along the lines of comparative advantage, as was advocated by Ricardo and seen in the context of 19<sup>th</sup> century Europe.

The similarities between the trade regime of the latter half of the 19<sup>th</sup> century and the regime of the latter half of the 20<sup>th</sup> century are the result of their common root in liberal economic theory. However, the GATT regime fundamentally differed from its predecessor in regards to how it conceived the role of government intervention domestically. Polanyi notes that during the period of the first free trade regime, people believed that “...the three tenants [of the *laissez-faire* system]—competitive labor market, automatic gold standard, and international free trade—formed a whole.”[15] In other words, states subscribed to the belief that liberal economic policies had to be adopted fully, or not at all.[16] As such, nations like England were prepared to sacrifice whole industries in the pursuit of comparative advantage. Such actions were highly detrimental to certain groups in society, and history has shown that they can lead to domestic instability.

In contrast, Ruggie claims that in the post-War era, states still saw the benefit in free trade externally; however, they had an equally strong interest in domestic economic growth and social security.[17] Furthermore, they understood that these socially optimal outcomes could not be achieved without government intervention. Ruggie dubs this economic system of externally liberal and internally Keynesian policies as ‘Embedded Liberalism.’[18] Harkening back to Wendt's Constructivist theory, which draws the link between ideas, interests and regime structure, Ruggie explains how the historical experience of the failure of free markets during the inter-War period fueled an ideational change. He notes that after this experience, a blind “...trust in the methods of *laissez-faire* doctrine [would have been] a doctrinaire delusion which disregarded the lesson of historical experience.”[19] This change in ideas led to a change in interests, which produced a different regime structure, as seen through the GATT. It was a regime that called for a reduction in trade barriers, while providing loopholes to minimize the destabilizing and costly effects of a fully competitive economic system.[20]

While the Constructivist paradigm provides a comprehensive explanation for the similarities and differences between

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the late 19<sup>th</sup> and late 20<sup>th</sup> century trade regimes, both Liberalist and Realist approaches fail to do this to the same extent. In his article, Kindleberger outlines the disparate domestic interests in each state, both for and against the move to free trade in the 19<sup>th</sup> century. He points to the varying nature of these interests to discount a liberalist, or domestic level argument for the creation of this regime. Kindleberger asserts that it is implausible for such a diverse range of domestic pressures to simultaneously pull numerous European countries towards the same outcome of free trade.[21] This argument can be similarly applied to the free trade regime in the post-War context. In contrast, the Realist explanation turns to the system level of analysis. Krasner outlines this perspective, claiming that open trade regimes or structures are established by hegemonic powers, and that the level of openness of trade is a function of the relative power of the hegemon.[22] However, as Ruggie notes, while systemic state structure may determine the form of the trade regime, it cannot explain the content.[23] In the context of both free trade regimes, the international structures were quite similar, as Great Britain, followed by the United States, were prominent hegemonic powers. However, the divergent domestic policies of these two regimes demand a more nuanced analysis that looks beyond systemic explanations.

The trade regimes of the late 19<sup>th</sup> century and the post-War period shared a common root in the liberal economic ideas of Smith and Ricardo. Nonetheless, they fostered opposing policies regarding the role of government intervention in domestic markets. This difference was caused by the normative shift that occurred between the two periods, a result of the failure of liberal economic policies, which led to the Great Depression. In effect, these two free trade regimes were at the same time bound together, and pulled apart on the currents of ideas.

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[1] Mark Brawley, *Power, Money and Trade* (Toronto: Toronto University Press, 2009) 50.

[2] *Ibid.*, 49.

[3] Alexander Wendt, "Anarchy Is What States Make of It: The Social Construction of Power Politics" in *Essential*

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[4] Adam Smith, John B Wright, George Osborne, *The Wealth of Nations*, reprint, ed. Jonathan B Wright (London: Harriman House, 2007) 7.

[5] David Ricardo, *The Works of David Ricardo* (Princeton: J. Murray, 1846) 75.

[6] *Ibid.*, 75.

[7] Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press Books, 1957) 143.

[8] *Ibid.*, 143.

[9] C. P. Kindleberger, "The Rise of Free Trade in Western Europe, 1820-1975," *The Journal of Economic History* 35 no. 1 (March, 1975) 40.

[10] *Ibid.*, 40.

[11] *Ibid.*, 41.

[12] Kyle Bagwell, Robert W. Staiger "An Economic Theory of the GATT," *The American Economic Review* 89 no. 1 (March, 1999) 217.

[13] *Ibid.*, 215.

[14] John Gerard Ruggie, "International regimes, transactions, and change: embedded liberalism in the postwar economic order," *International Organization* 36 no. 2 (Spring 1982) 397-9.

[15] Polanyi, *Great Transformation*, 144.

[16] *Ibid.*, 144.

[17] Ruggie, "Embedded Liberalism," 340.

[18] Ruggie, "Embedded Liberalism."

[19] *Ibid.*, 388.

[20] *Ibid.*, 397-9.

[21] Kindleberger, "Rise of Free Trade," 51.

[22] Stephen D. Krasner, "State Power and the Structure of International Trade," *World Politics* 28 No. 3 (April 1976) 332.

[23] Ruggie, "Embedded Liberalism," 382.

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