

FREE TRADE, BUSINESS STRATEGY AND GLOBALIZATION^(a)

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ABSTRACT

This paper links the economist's analysis of free trade with the business strategist's analysis of the forces behind the globalization of competition. It argues that, although the drive to globalization may seem different from the seeking of superior outcomes in competitive markets, this may be only because the modern reference point for competition is inappropriate. However, reference back to classical ideas of competition shows that both the advantages of globalization, and its disadvantages, had been anticipated by classical writers of the eighteenth century, most notably by Adam Smith.

I. INTRODUCTION

Globalization is viewed with admiration by some and fear by many. Yet, how new is the doctrine, when viewed from the perspective of free trade theory? Nation states have long been willing to put their authority and good-will behind free trade measures. The General Agreement on Tariffs and Trade (GATT) rounds of tariff reductions are the most obvious example. This agreement came into being in 1948, at which point Keynesian ideas, associated with interventionist policies at the national level, had taken root. Yet even Keynes became a free trader before the end of his life¹. GATT pledged member nations to commit themselves to multilateral trade. In doing so, they agreed to reduce barriers to trade, to reduce import tariffs and quotas, and to abandon preferential trade agreements².

By acting in this fashion, member countries in a Keynesian era were, even then, harking back to views first articulated by Adam Smith and David Hume in the Scottish Enlightenment of the eighteenth century³. These ideas, as regards their analytical dimensions, were developed by Heckscher (1919) and Ohlin (1933) in the context of a static general equilibrium model. They were subsequently given more rigorous expression by the likes of Samuelson (1948) and Kemp (1964). In doing so, these theorists took free trade some distance from the intentions of the earliest writers. As a counter balance to this bowdlerisation, free trade as a doctrine has more recently been re-invigorated by the writings of the Austrian economists, like Hayek, Lachmann, Mises, Rothbard and Kirzner⁴. They have re-asserted the importance of treating competition as a dynamic process, rather than as a static equilibrium state.

II. GLOBALIZATION TODAY

The term globalization has taken over from related economic terms like 'internationalization' and 'transnationalism'. The only research unit in the world which is dedicated to globalization and its links with regionalization is the Centre for the Study of Globalization and Regionalisation (CSGR) at the University of Warwick, England. In stating their research agenda⁵ the CSGR admits that globalisation 'remains an imprecise term'. The CSGR ends up by defining globalization in terms of phrases like 'a process unfettered by territory' which 'stimulates novel language and imagery' for the purpose of 'dealing with evolving reality'. Unfortunately, in seeking generality, they sacrifice getting a grip on any tangible fact or relationship.

A radical account, such as that of Amin (1997) would present globalization in terms of a stark characterisation. In the case of Amin, this takes the form of what he calls 'the five monopolies'. These are monopolies based on technology, finance, natural resources, mass media and weapons of mass destruction, respectively. Another way of looking at globalization is in terms of a mosaic of features like⁶: multinational enterprises (MNEs) exploiting arbitrage possibilities across tax jurisdictions; the lowering of transaction costs by developments in transport and communications; the rise of service activity, especially of the financial variety, sidelining merchandise trade; the rise of newly industrialised economies (NIEs) in terms of the share of world trade, through exploiting the international division of labour; and the

rise of economic policy to dominance over defence and foreign policy. These three views of globalization all address the same object, but view it, as it were, from different angles, or in a different light.

Whatever the perspective, common features occur in most contemporary accounts of globalization. The key one focuses on the ability of MNEs to operate globally i.e. in any desired territory of the globe. This seeking of a desired territory is frequently, indeed typically, governed by the exercise of power by the MNE, to avoid or minimize the impact of any state upon its operations e.g. in terms of regulatory or tax regime. Finally, the capacity of the MNE successfully to pursue global operations has been greatly heightened in recent decades by advances of information technology. This has made all forms of multinational operations more efficient, notably in the speed at which actions can be taken, like the movement of resources (e.g. finance capital). Further, it has led to most rapid growth in those activities which are themselves most information intensive, like corporate services and international finance, Sassen (1997).

In seeking to understand better these effects, research on the quantification of globalization is turning to new issues like the regionalisation of production, including the increasing concentration of activity in super-city sites like London, New York and Tokyo. However, an ever present concern in measuring the advance of globalization is with calibrating the integration of territories by the volume of cross border trade.

The level of integration of territories can be expressed as the ratio of goods and services that cross frontiers to goods and services produced world wide. This has been called 'the export ratio of production'. By 1913 it was two thirds, and today it is just slightly less. If integration in this sense is meant, the high point was the period just before the First World War. It is clear from scholarly research [e.g. Kuznets (1967)] that globalization is something more than the greater integration of economic territories. The latter process has been going on since the end of the eighteenth century, Kindleberger (1975). Indeed it dates from the emergence of the free trade doctrine, which was itself a protest against the inefficiencies of the prevailing doctrine of mercantilism. The salient features of data over the nineteenth and twentieth centuries, are that: the greatest activity in world trade was between 1890 and 1914; the proportion of world trade attributable to countries by development phase was relatively stable; few joined the 'core' of developed countries; inter-group, intra-industrial and intra-non-industrial trade have generally had stable proportions over time; the proportion of world trade attributable to core nations by population declined.⁷ Put briefly, the 'core' of developed countries is stable and increasingly exclusive.

III. ECONOMICS AND BUSINESS STRATEGY

International business specialists who come to the subject from an economics perspective, tend to see merit in trying to meld the economics and business strategy perspectives. Most notable in this respect are, perhaps, the works of Dunning (1993) and Porter (1990). In Porter, the approach is very firmly based on economic principles, especially those arising from industrial organization. In that sense, Porter, as a business strategist, is some distance, in terms of methodology, from the likes of Mintzberg (1994). The latter emphasises cognitive factors to a much greater degree, and is therefore more concerned with motivational issues. By contrast, Porter assumes these will be bound in with the usual economic assumption of self interest. Thus Mintzberg emphasises heavily the imaginative thought processes of the entrepreneur, especially those at play in constructing a vision of the future form of the enterprise. Porter is more prosaic, and many key elements of his construction are based on empirical studies of actual market outcomes.

The central construction of Porter (1990) is his 'diamond' analysis of the competitive advantage of nations. Competitive advantage, in Porter's sense, means the ability of firms in a nation to use their location-bound resources to compete successfully on international markets. The 'diamond' is a schematic diagram which links a nation's key industrial characteristics. These are: goods markets; factor markets; firm strategy/structure/rivalry; and related/supporting industries. They are related by a diamond shaped set of connections, suggesting mutual causation and reinforcement. At play on these features of a nation's competitive advantage are systematic influences, from multinational business activity (MBA) and government, and random influences. Then, according to Porter (1990, p.71) this diamond sets out the attributes, and their links, which 'shape the environment in which local firms compete, and which promote or impede the creation of competitive markets'.

The competitive advantage which a nation achieves, according to analysis based on this diamond, is measured by the value of its national product and/or its rate of growth, in relation to its principal rival nations. Thus the diamond is telling us how the range and quality of goods and services supplied by a nation on international markets compete more,

or less, successfully with goods and services of rival nations. In many ways, the construction of Porter's main line of argument is a direct extension, to the nation, of his earlier analysis of the competitive advantage of a firm, and how competitive strategy can best be deployed to achieve it.

Porter's work has been very influential in presenting a well articulated framework for competition among nations, as distinct from firms, and is a standard reference on global strategy. What it says is noteworthy in its own right, but also, as we shall see, bears a strong relationship with an established line of analysis, that can be associated with classical writings. Global industries are said to have the characteristic that different nations compete within them in a way which has a significant impact upon national prosperity. This is a direct borrowing of the notion of strategic interaction from mainstream industrial organization, especially the more game theoretic part of it. So conceived, global strategy must adopt a worldwide approach to attaining competitive advantage. The principal dimensions of such a strategy, Porter (1990, p. 55) argues, are configuration and coordination. That is, one asks where, and how, activities are dispersed across nations, and how are they coordinated.

In his treatment of the deployment of strategy, Porter (1990, p. 54) encapsulates the essentials of his argument in the statement: 'This creates scale to amortize R&D costs and to allow the use of advanced production technology'. There is an emphasis on leadership in the successful pursuit of global strategy, typically from constant innovation, Porter (1990, p. 65). Thus, a dynamic approach is crucial to the pursuit of competitive advantage: 'firms that rest on a static conception of advantage...lose market position', Porter (1990, p.68). In relating his thought to established economic analysis, Porter (1990, p. 20) emphasises that 'competition is dynamic and evolving' with 'improvements in innovation in methods and technology a central element'. This he contrasts with a static, general equilibrium view of competition, where best returns are sought, with given technology. In brief, Porter is arguing that competition is a process, and essential to this process is constantly improving how activities are performed.

I do not know whether Porter (1990) in choosing his title *The Competitive Advantage of Nations* was influenced by Adam Smith's (1776) title of his great work *The Wealth of Nations*, but he might well have been. Indeed, one notes the resemblance in both method and style. It has often been said that Smith simply drew on received knowledge in providing his analysis of the wealth of nations. As much has been said too of Porter. Indeed, Dunning (1993, p.106) has expressed the view that: 'In one sense, there is nothing original in Porter's analysis. Throughout history, a succession of scholars have attempted to identify and evaluate the supply and demand conditions necessary, for a country to be competitive in world markets'. Though Dunning also notes the less comprehensive treatment of Porter compared to others like Smith, there remain similarities. Both Smith and Porter draw skillfully on a variety of analytical ideas of their contemporaries to create a simple, yet powerful synthesis. In each case, dynamic, rather than static competition, and continuous innovation, rather than given technology, are central. Indeed, it is not just that innovation is continuous in each case, but that it is also endogenous.

The main point I should like to make in this article is that the phenomenon of globalization, including its strengths and weaknesses, can be better understood by reference to classical analysis. By this, I do not mean simply the reading of the classics, notably Smith (1776). More than this, I mean interpreting the classics through a modern lens, (Reid, 1985,1987). Two particular points at which classical analysis seems to have an advantage, in terms of understanding and interpreting globalization, are as follows: first, the treating of system-wide behaviour in an historical epoch as part of a stage in the evolution of societies; second, the treating of competition as a process over time, involving profit seeking and innovation, in the face of disequilibrium conditions. I shall treat in turn stadia analysis, and then competition, in what follows.

Smith developed a stadia analysis (i.e. an analysis in terms of a sequence of stages) of societal evolution, with his four stages being hunting, pasturage, agricultural and commercial. This laid the basis for further work on stadia analysis by Scottish enlightenment figures, including Adam Ferguson and William Robertson. This stadia approach was also a great influence on Marx, who in his economic analysis, at least, was something of a conservative. He borrowed much, largely unmodified, from classical writings. Economists have continued to find stadia analysis appealing, two notable contributors of the twentieth century being by Rostow (1960) and Hicks (1969). Since they wrote, serious work has been devoted to identifying possible (and new) stages of society, such as the post-industrial order identified by Bell (1974). In the radical economics literature, a common reference point (for viewing the beginning of globalization as a new stage in societal evolution) is Lenin's (1939) analysis of imperialism. In essence, the features Lenin identified for this new stage were the growth of large monopolies in advanced industrial nations, the rise from amongst their numbers

of a few capital rich countries, and their seeking of profitable outlets for excess capital. When he first identified this stage 'at the threshold of the twentieth century', in fair measure the empirical observations he made were sound. However, the prescriptive judgments superimposed on these observations have been, viewed from the threshold of the twenty first century, less than far sighted. His reference to 'a shell which must continue in a state of decay'⁸ has been less than prophetic. One hundred years later, what we recognize now as globalization - what Lenin, in anticipating it, called imperialism - is very much a vigorous focus for societal change and wealth creation. Indeed, it seems likely that we have only just begun to see the beginning of the potential impact of globalization, viewed in terms of a societal stage.

In my own treatment of the stadiad analysis of Smith (Reid 1989 a, b), each stage is taken to be consistent with a certain constitutional order⁹. That order will stay in place until all economic potential that it may possess becomes exhausted. The conclusion of a societal stage, that is the stationarity of part of a growth sequence, has then been signaled, and forces of self interest tend to come into play stimulating a new constitutional order. What seems apparent, is that globalization as a societal stage, is far from exhausted, in terms of its economic potential. As a stage, its unique characteristic is that it goes beyond the institution of any single nation state. Previous stages appear to have been past features of nation states. Thus feudal, mercantile, industrial and post-industrial stages were experienced by nation states. Advanced economies all seem to have gone through these stages, though not all at the same time. Suppose we admit globalization, as a stage which, arguably, comes after the post-industrial. By its nature, a plurality of states is now simultaneously participating in the progression of this stage. This convergence of nation states on one stage has come about because of the advances in information storage, processing and handling which occurred in the latter part of the twentieth century. The sharing of nation states in this process has diminished the significance of states per se, and increased the significance of the information forms that bind them together in a common experience. As the CSGR put it¹⁰ 'globalization as knowledge constitutes a new reality and renders redundant the language and imagery of a state-centric world'.

In the progression of the stage of globalization, a process of competition is at work. In the same way as a Smithian perspective is helpful in embedding globalization in a stadiad analysis, so too it is helpful, I would argue, in characterising the form that competition takes within this stage. What I have to say on this issue can at least in part be expressed in algebra. However, to keep the reasoning accessible, I have confined the relevant mathematics to an Appendix.

The broad line of reasoning is as follows. In the search for global competitive advantage, a market leader takes the initiative in terms of innovation and price setting. To keep the argument simple (and, actually, not too far from reality) it is assumed that unit costs (and marginal costs) are constant and equal, up to capacity output. Competition is dynamic and profit-seeking. It occurs over a sequence of time periods, and innovation is only undertaken if it offers a profit advantage. Price is a mark-up on direct costs, with the margin creating a discretionary surplus which can be allocated to R & D. The discovery and implementation of a profit making innovations are aspects of the advanced division of labour, sometimes called 'the division of thought', Casson (1988).

The above paragraph is directly based on classical reasoning. However, it is also consistent with Porter's analysis, outlined above, of the search for international competitive advantage. The analytics of this approach can be developed informally as below. For more detail, the reader is referred to the Appendix.

The market leader engages in a strategy of price cutting, innovation, and capacity expansion. It determines what price will prevail in the market by setting a constant mark-up on unit cost. This mark-up creates a fungible surplus which allows discretion to be exercised e.g. over the distribution of profit from surplus or the allocation of surplus to R & D activity. Innovation is cost reducing, and capacity expanding. By its adoption and implementation, it is implied that the profit generated exceeds that in the previous time period. In this sense a kind of 'satisficing' approach is implied, with the market leader seeking improved performance, rather than the will o' the wisp of optimal performance.

If the unit cost at capacity of the market leader is tracked over time, its locus has a form which identifies discrete points on a falling long run unit cost curve. In this sense, by pushing on innovation, lowering unit cost, and expanding capacity, the market leader is exploiting dynamic scale economies. This, based on classical reasoning, is precisely the picture envisaged by Porter. It clearly also involves, as he suggests in his own analysis, the amortization of R & D expenditure over a greater scale of output, *cf.* Porter (1990, p.54).

In pursuing competitive advantage in this way, the market leader puts following firms at a competitive disadvantage. They operate at lower scales of operation, with higher unit costs. Margins are constantly squeezed by the downward

pressure on price exerted by the market leader. There is a kind of hierarchy of leaders and followers, with (in the starkest scenario) no variations in relative position, and life getting harder the further you go down the hierarchy. If an element of chance is introduced into the innovation process, this creates at least some prospect for firms 'close' to the market leader, in terms of technology, being able to 'leap-frog' the current leader or higher ranked followers.

If global market demand is increasing less rapidly than the sum of capacities of all firms active in this sector, then the most disadvantaged followers will tend to be forced out of the market. Indeed, if demand were static, this process would be rapid, and increased concentration of industrial output would ensue, followed by ultimate monopolisation. This is the doomsday scenario predicted in the radical critique of globalization, which in turn has its roots in Lenin's earlier analysis of imperialism.

However, there are reasons to think that this stagnation of demand will not occur. The roots of the argument, which explain why this may not happen, are to be found in the work of Young (1928), and especially, Kaldor (1970, 1972). What Young and Kaldor have pointed out is that technologies of the sort we have been discussing display dynamic increasing returns. This effect is entirely destructive of competition in a neoclassical sense, as no 'general equilibrium' may exist. If it does, it may be unstable. This leads to an important alternative view of the competitive process which may be dubbed 'cumulative causation'. As Young (1928, p.533) put it 'change becomes progressive and propagates itself in a cumulative way'. In a nutshell, the argument is that the increased surpluses which market leaders enjoy, as they press on with innovation, and enjoy greater scale economies, create induced investments which increase effective demand. Thus the cycle of increased scale, greater economies, enlarged surpluses, increased demand, is reinforcing, hence the term 'cumulative causation'. The conditions under which this will occur were sketched by Young, tightened up by Kaldor, and expressed with reasonable precision by Hahn (1989). Essentially, the conclusion of Hahn (1989, p.53) is that Kaldor overstated his theoretical case, which had been expressed very strongly, in phrases like 'there are no resource constraints in the long run'. However, with certain forms of expectations and increasing returns, 'cumulative causation' can occur. Kaldor (1970) himself, in introducing his argument in a regional context, was also at pains to point out that the mirror image of cumulative causation, and the so called 'virtuous circle' of growth, increasing returns, and further growth, is the 'vicious circle' of decline, increasing costs and further decline. Indeed he pointed out that virtuous circles and vicious circles could develop side by side in different regions which were part of an integrated economy. In doing so, he deployed classical analysis to anticipate North-South problems of the globalized economy.

IV. CONCLUSION

Globalization is an issue that has captured the popular imagination, both positively and negatively. It has also been the focus for much academic research, though here again, quite different approaches have been adopted by various scholars, leading to divergent views. My purpose here has been rather different from either the popular or extant academic approaches. It has been to anchor contemporary analysis of global strategy firmly in the classical mode of thought. I have supported that argument with two main lines of reasoning. The first identifies globalization as a further stage in the stadial analysis of societal evolution. The second identifies the competitive actions taken in implementing global business strategy as consonant with the analysis of competition as a dynamic process in classical economics.

In turn, these two ideas were linked, stadial analysis, and process competition, to provide the basis for a 'cumulative causation' argument about the extension of markets and competition. In this approach, rooted too in classical analysis, expansion of production, innovation and increasing returns go hand in hand, causing a progressive spiral of growth. However, this same process can cause 'vicious circles' as well as 'virtuous circles'. If demand starts to stagnate, this tendency can be self-reinforcing, with firms who are not industry leaders going to the wall, and a tendency to monopolisation asserting itself.

Thus the process of globalization needs to be guided, as a 'virtuous circle' is not a necessary outcome. Such guidance mechanisms should not be used to blunt the market mentality, nor to reverse the trend of liberalisation. However, they need to be put in place to guard against instability and stagnation.

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APPENDIX

Price is set as a mark-up on unit direct cost. It may be expressed as:

$$p(t) = c_i(t) + \pi_i(t)$$

$$= [1 + k_i(t)]c_i(t) \quad \text{with} \quad k_i(t) > 0$$

where $p(t)$ is the (uniformly adopted) price set by the market leader, $\pi_i(t)$ is the profit margin of the i 'th firm, $c_i(t)$ its unit direct cost, and $k_i(t)$ the percentage profit mark-up. The market leader sets the price and this firm is indexed $i = 1$. Technical progress is determined by the division of labour, which, in its advanced state, extends to a 'division of thought' i.e. advanced intellectual specialisation.

Technical progress involves *cost reduction* and *capacity extension*. The market leader has a lower unit cost (c) than h periods ago, and a higher capacity output (a):

$$c_1(t) < c_1(t-h)$$

$$a_1(t) > a_1(t-h)$$

Firms $i = 2, 3, \dots$ that do not lead, adopt earlier forms of plant, implying

$$c_i(t) = c_1(t-h_i)$$

$$a_i(t) = a_1(t-h_i)$$

for positive integers h_i and i . An innovation will only be adopted if it is *valuable*, in the sense of promising higher profit in a subsequent period. For simplicity, ignore discount rates (or else think of algebraic formulae as being expressed in discount equivalents). Then if the market leader adopts an innovation in period $(t+1)$ it must satisfy

$$\pi_1(t)a_1(t) < \pi_1(t+1)a_1(t+1)$$

or $\Pi_1(t) < \Pi_1(t+1)$

where Π denotes total profit, and I assume the market leader always produces at capacity. Then it is easy to show that followers are always at a competitive *disadvantage* compared to the market leader. Intuitively, the result holds because followers use plant of vintages that the leader had used previously. Followers thus have lower capacity, higher unit cost, and a squeezed margin (assuming a leader's constant margin) which limits the surplus from which they can make an allocation to R&D.

More formally, if the price trajectory set by the leader is $p(t) = [1+k]c_1(t)$ then a follower's (same) price is $p(t) = [1+k_i(t)]c_i(t)$. But $c_i(t) > c_1(t)$, hence $k_i(t) < k$, the *margin* or mark-up *squeeze*. Thus $\pi_i(t) < \pi_1(t)$, which with $c_i(t) > c_1(t)$ and $a_i(t) < a_1(t)$ implies that $\Pi_i(t) < \Pi_1(t)$, the *surplus squeeze* (where π_i is unit profit and Π_i is total profit).

Not only is this squeeze contemporaneous. It is easy to show [See Reid (1989b, pp.90-91)] that the follower firms experience inferior competitive advantage to that enjoyed by the leading firm in the past, in the sense that $\Pi_i(t) < \Pi_1(t-h_i)$. That is, profit is less for the operation of this vintage of plant by followers than it was when used h_i time periods earlier by the market leader. A similar algebraic argument has been used by Baumol et al. (1982) to deny their earlier inter-temporal un-sustainability result. That earlier result seemed to suggest that natural monopoly invites profitable entry in later periods (hence 'un-sustainability'). However, if learning lowers unit (and marginal) cost, inter-temporal monopoly is shown to be sustainable. This suggests a strong tendency to sustain first mover advantage. The result can

be weakened if leaders have only a superior probability (rather than certainty) of discovering the next innovation. This allows for the possibility of followers 'leap-frogging' leaders, so the identity of the market leader may vary over time.

END NOTES

1. See Harrod (1951, p. 622) where he summarised Keynes's view in 1946 by the following: 'The long run mechanisms of the classical system must be allowed to work.....Economic liberalism was consonant with British traditions.'
2. Today, GATT is often linked in the mind with the World Trade Organization (WTO). Indeed, the acronym GATT-WTO is quite common. The WTO has been seen by some [e.g. Amin (1997)] as enforcing GATT regulations, without regard to domestic law, and thus as promoting multinational interests over national interests.
3. Specifically, one has in mind *The Wealth of Nations* by Adam Smith (1776), which will be the focus of this paper. Also important and relevant are the essays on commerce, interest and the balance of trade in the *Political Discourses* (1752) by David Hume.
4. A range of writings in this vein is reported in Spadaro (ed.) (1978). This work includes contributions from Lachmann, Rothbard, and Kirzner, that build on the earlier writings of Hayek and Mises.
5. (<http://www.warwick.ac.uk/fac/soc/CSGR/agenda.html>)
6. These features are also identified by the CSGR to give concrete examples of why globalization matters.
7. These are the empirical generalizations of Kuznets (1967) as updated by Hoogveldt (1997) using GATT and UN statistics. The main points of change arising from this updating relate to: (a) the extension of the 'core' by the rise of Japan and the 'Asian Tigers', viz. Singapore, Hong Kong, Taiwan and Korea; and (b) the rise in intra-industrial group trade - from 45% at the end of the nineteenth century to 55% at the end of the twentieth century.
8. See Frieden and Lake (eds.) (1995, p.119).
9. This is a slightly less general framework than that advocated by Douglas North (1994). He would think in terms of informational and institutional requirements for sustaining a societal stage. I have used the phrase 'constitutional order' partly figuratively to capture more than just a constitution, but my intention is similar to North's.
10. See CSGR web-site p.3.

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