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The American Scholar Forum

THE COMING ECONOMIC WORLD PATTERN

Free Trade or State Domination?

Henry Hazlitt

Freedom of trade, in the eyes of Adam Smith and his nineteenth-century successors in the liberal tradition, meant freedom from government interference. All that the "classical" economists asked of governments in the field of international trade was that they should *permit it to occur*. They wanted a removal of prohibitions and of nearly all tariffs. But they did not ask for positive "encouragement" or artificial stimulants. They were as much opposed to bounties as they were to barriers.

What the older liberals meant by freedom, in short, was freedom of the individual citizen. They asked that he be free to sell his goods to whatever country and whatever market would pay him the best price for them. They asked that he be free to buy whatever he wanted wherever he could get it cheapest. They argued that these freedoms were not only good in themselves, but that they represented by far the best means to bring about the most efficient division of labor and to maximize world production and world consumption. All they asked of government was that it enforce the laws against fraud, force, and theft and that it refrain from debasing the currency.

The world barriers to international trade in the nineteen thirties, for which every large nation was in part responsible, but in the erection of which the totalitarian governments went to the greatest lengths, brought about such chaos that few responsible persons now undertake to defend them. High tariffs, import quotas, export subsidies, competitive currency depreciation, blocked currencies, bilateral arrangements, forced barter — all these are today deplored by lip in all respectable circles. The demand now is for International Cooperation.

I

But when the concrete proposals for this international cooperation are examined, it turns out to be something radically different from the international cooperation hoped for by the older liberals. It is not the freedom of the private citizens of any country to trade with the private citizens of any other. It is not primarily the cooperation among private citizens of different countries at all. It is primarily cooperation among governments. As in the thirties, it is governments that are going to take the matter in hand. But instead, as in the wicked thirties, of restricting trade and making economic war

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The exigencies of time made it impossible for the two contributors to this number's Forum to read each other's papers before publication. Both contributors have been invited to reply by letter, for publication in the Spring issue.

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upon each other, this time, we are told, the governments are going to direct and stimulate trade in the interests of peace.

It is a pleasant fantasy; but there are the gravest reasons for doubting that it will ever be realized. There are the strongest reasons, on the other hand, for fearing that this kind of intergovernmental cooperation will break down, and that when it does the resulting chaos in international trade and economic relations will be greater than ever.

For government officials, even when they really understand (which is very rarely) the basic economic forces that they are trying to control, are almost never disinterested. They are almost certain to reflect the special interests of some political pressure group. The interests of the pressure groups represented by the bureaucrats of one nation are certain to clash with those of the pressure groups represented by the bureaucrats of another. And these conflicting interests, precisely because they are represented by their respective governments, are far more likely to clash openly, directly and politically than in a world of genuine free trade.

But perhaps, before we come back to these larger issues, it would be well to examine in detail the leading proposals so far put forward for the postwar economic world.

The agreements reached by the experts at Bretton Woods seem to typify the intended shape of things to come. The proposed International Monetary Fund has as one of its ostensible purposes the promotion of "exchange stability." Now the way to secure exchange stability, as worked out before the first World War, was clear. A nation kept its own currency sound. It made it convertible on demand into a definite and fixed quantity of gold. To make sure that the promise to pay that fixed quantity of gold would be kept, it saw to it that there was not an excessive expansion of bank credit. It saw to it also that the central government did not issue such a volume of debt that its ability to maintain interest on that debt and to retire it would come into question. A nation saw to it that the government's bonds were sold to the public, so that they were paid for out of real savings and not merely out of the creation of additional bank credit. If a government were to meet all these requirements it had to balance its budget, or at least make certain that its budget was not too long or too heavily out of balance.

When the public was confident, as a result of these conditions, that the promise of gold convertibility would be kept, a nation's currency in the foreign exchange market was stabilized (with comparatively minute fluctuations) in terms of this fixed gold value. The currencies of other countries were likewise fixed in terms of definite gold values. As each currency was held, by each country's own policy, to the value of a fixed quantity of gold, it followed that each gold currency was necessarily fixed in terms of every other. General exchange stability was preserved.

This was the international gold standard. It was a form of international cooperation worked out and perfected through the centuries. It reached its highest development in the latter part of the nineteenth century and in the present century before the first World War.

II

One will look in vain through the Articles of Agreement on the International Monetary Fund for any reference to balanced budgets, to limitations on internal credit expansion, or to any definite requirement for gold convertibility. How, then, does the Fund propose to maintain international currency stability? Instead of contemplating that each currency shall be separately anchored to gold, and that each nation shall be responsible for maintaining that link so far as its own currency is concerned, the Fund proposes that every currency be tied directly to every other. This is to be done by forcing the strong currencies automatically to support the weaker.

Suppose, to take a fictitious example, that the Ruritanian rurita has a par value of twenty cents in terms of American dollars. Suppose it has a sinking spell, or that everybody shows a sudden desire to get rid of ruritas and to acquire dollars instead. It becomes the duty of the Fund to supply these dollars, at least up to an amount stipulated in advance in the Articles of Agreement. The Fund must keep buying the

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ruritas at twenty cents. It must do this regardless of whether the rurita is sinking because the Ruritanians are buying more goods from the outside world than they have the exports or credit to pay for, or because Ruritania is having a revolution, or because it has a Fascist government that has just announced that it is expropriating the property of some minority group, or because it has a budget deficit brought about by a heavy armament program, or simply because it is grinding out too much paper money on its printing presses.

Now the real value of the rurita, left to the natural play of supply and demand, may be only two cents. Nevertheless, it must continue to be bought by the Fund at twenty cents. But if, as is most probable, it is being bought by dollars, this means that American taxpayers are buying two-cent ruritas for twenty cents, thereby immediately losing 90 per cent of their investment on each purchase, while they pay for Ruritania's luxury imports, her armament program or her Fascist experiment.

But does the International Monetary Fund, though it explicitly lists that objective among its purposes, even contemplate exchange stability? On the contrary, it clearly contemplates a great deal of exchange instability. It provides, first of all, that any nation may at any time devalue its currency 10 per cent. It is explicitly stipulated that "the Fund shall raise no objection." Any nation may propose a devaluation of its currency by another 10 per cent, and the Fund must either concur or object within seventy-two hours. The practical effect of this pressure for a quick answer will be to give the benefit of the doubt to the nation that wants to devaluate. If a nation wishes to devalue its currency even further, it must consult the Fund. But if the Fund refuses its request the member can simply withdraw, without advance notice, if it prefers further devaluation to whatever additional automatic credit it might still be entitled to in the Fund.

But the most ominous provision of the Fund, from an inflationary standpoint, is that which permits it by a majority of the total voting power to make "uniform proportionate changes in the par values of the currencies of all members." Each such change must be approved also by every member that has 10 per cent or more of the total of the quotas. It is true that an individual member of the Fund, if it decides within seventy-two hours, may be allowed to keep the par value of its currency unchanged; but as devaluation of all other currencies would be certain to cause a prompt drop of commodity prices within a non-devaluing nation, all nations would be virtually forced to participate in the devaluation.

Now this provision of the Fund is a provision for periodic world inflation. The historic instances in which the par value of the monetary unit has been increased are so rare as to be negligible. The practical political pressures are always in the other direction. So we are safe in assuming that the "uniform proportionate changes" referred to by the Fund mean uniform proportionate *devaluations*. Devaluation is the modern euphemism for debasement of the coinage. It always means repudiation. It means that the promise to pay a certain definite weight of gold has been broken, and that the devaluing government, for its bonds or currency notes, will pay a smaller weight of gold.

III

When a nation devalues by acting alone, all this is plain enough. Foreigners who hold bank deposits in that nation, or exchange bills drawn on that nation, or any obligation of that nation stated in terms of its own currency, know that they have been cheated. The value of their claims in terms of their own currency immediately drops by the percentage of the devaluation. They will be paid only 90 or 80 or 50 cents on the dollar. All this makes devaluation morally embarrassing to the devaluing nation.

There are other embarrassing effects. Devaluation seldom comes out of a clear sky. It follows an overexpansion of the government's debt or currency notes or an overexpansion of internal bank credit. Foreigners, reading these signs, begin to withdraw their deposits. The nation's own citizens, seeking to protect their own position, begin to transfer their deposits to other countries that look

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safer. This is called the flight of capital. The politicians in power, and economic writers who reflect their point of view, seek to put the blame, not on the government that has made its credit and intentions questionable, but on the creditors who question them. They call the money of these creditors hot money — though it is, of course, merely money that is trying to leave hot places. In spite of this modern vocabulary, nations are still embarrassed by this flight of capital and this public evidence of distrust. Moreover, it is a blow to national pride and prestige for a nation's currency to sell at a discount in the foreign exchange markets.

It is obvious that a *uniform* depreciation of *all* currencies would either remove or conceal most of these embarrassing results to a single government. Though the dollar, say, would go to a discount of 25 or 50 per cent, the man in the street would hardly suspect it at first because all the external measuring rods would have shrunk in exact proportion. A hundred dollars would still be worth the same number of pounds, francs, marks, lire, rubles, and so on, as before, and vice versa, because they would be different pounds, francs, and rubles as well as dollars. Relative foreign exchange rates would remain unchanged. There would be no flight of capital, because every place to which it could go would be equally disadvantageous. The provision in the Fund for world inflation, in brief, is a provision to make resort to inflation easy, smooth, and above all respectable.

But the real harm that inflation would do would be no less under world-wide inflation than under national inflation. Commodity prices would rise. Everybody's cost of living would go up. Those who lived on pensions, either private or part of government social security systems, would find them buying less than before. The holders of government securities would find the real value of their securities greatly cut. All those with fixed incomes would find themselves subjected to an invisible but real and ungraduated income tax (in addition to the government's acknowledged graduated income tax). All those with savings accounts and insurance policies would find them cut by an invisible but real and uniform capital levy. In short, private citizens, as before, would be cheated by their governments; but the government propaganda agencies would assure them that the latest inflation had merely ushered in a new paradise.

The proposed International Monetary Fund is bad from so many aspects that it is difficult to know in advance which danger will prove the most serious. By keeping up exchange rates by artificial means, buying currencies at par regardless of their real market value, and making devaluation easy and respectable, the way will be cleared for encouraging every government in power to follow the easy political path. It can continue to pay heavy subsidies to all sorts of pressure groups, to embark on public works and patronage on a grand scale, and to tax lightly, thus continuing chronic budget deficits and financing them by added debt.

But all this will not give us free exchange markets. The Fund Agreement does not say in so many words whether there will be a free foreign exchange market or not. But it provides for the continuance of controls during an indefinite "transition" period, and it encourages permanent controls over capital movements. To control international capital movements would in practice require supervision and policing of all exchange transactions. In practice, therefore, people could not buy or sell abroad, or travel, without going through a great maze of red tape to get permission from their government to do so. They would lose the power to dispose of their property as they wished, or to emigrate and take their money with them. Government power over the lives and actions of its citizens would be extended in yet further directions. Still more former freedoms would be abridged or circumscribed.

IV

Let us turn from the proposed International Monetary Fund to the proposed International Bank for Reconstruction and Development. Here at least is an institution in which, with proper safeguards, the possibilities for good might outweigh the possibilities for harm. The Bank, apart from its unnecessarily large subscribed capital

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($9,100,000,000), is set up on a comparatively conservative basis. It is not to lend or guarantee loans for more than the full amount of its unimpaired subscribed capital, reserves and surplus. It is not to make loans on an automatic basis, like the Fund. It can exercise discretion. A project, for example, for which funds are being asked must be deemed meritorious by a committee selected by the Bank. The borrower must be "in position to meet its obligations."

Such a Bank, in the decade immediately following the war, could perform a useful service. In particular, it could make loans to stabilize their currency to those nations that show a genuine will and capacity to do so. Whether the proposed International Bank would provide a better medium for this purpose than the existing American Export-Import Bank is a question of practical judgment. The International Bank would have the advantage of symbolizing international cooperation. There would be psychological and political advantages in making individual nations responsible for payment of their debts to a Bank representing forty-five different nations rather than to a bank merely representing one. On the other hand, while the United States would supply the lion's share of the lendable funds of such a Bank, and probably assume an even greater share of the risks, and while most of the loans would doubtless be floated in this market, our government would have much less to say about the loans and the conditions attached to them than if it were making them alone. While it is true that the American representative on the Bank would be technically free to veto a proposed loan made in dollars in this market, it might be made very embarrassing for him to do this.

It is not necessary here to weigh the relative merits of the proposed International Bank and our existing Export-Import Bank as a medium for making international stabilization loans. But it is important to point out that there are only two sound reasons why governments, either individually or jointly, should engage at this time in the business of international lending at all. The first is the whole record of default and repudiation of foreign loans in the inter-war period. This was brought about to some extent by real embarrassment on the part of debtors, but even more by the prevailing anti-foreign and anti-capitalistic ideology which regards the foreign lender, not as a man who takes risks and supplies essential aid, but as an "exploiter" who "throttles" the native economy. This record of default and repudiation has led to at least a temporary reluctance of private investors to make further foreign loans. The second reason why government intervention is now needed is that the terrific disruption brought about by war will make it extremely difficult for some nations to stabilize their currencies without outside help.

But whatever governmental institutions are used to make such loans should be temporary in nature. They should confine themselves to currency stabilization loans only. Where help is needed for humanitarian reasons it should be granted freely and generously, as a pure gift. The United Nations Relief and Rehabilitation Administration already exists for this purpose. Its scope may need to be expanded. But everything above this should be placed on a strictly business basis. It will never be placed on such a basis if it is managed by governments. Where loans are made by private groups, risking their own funds, they will be made, in the overwhelming main, where the risks seem smallest and the chance of profit greatest. Under these conditions world resources are likely to be utilized in the most efficient manner. But where loans are made by government officials who risk other people's funds and not their own, they are bound to be made primarily for political reasons and will often be wasteful from an economic point of view.

It is contemplated that the loans guaranteed by the proposed International Bank will be guaranteed first of all by some government. If the project for which the loan is made is located in Ruritania, for example, the Ruritanian government or central bank would have to guarantee the loan before the International Bank would do so. This would, of course, reduce the risk assumed by the International Bank. On the other hand, it would enable it to make loans only to proj-

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ects that had home government support. The home government, by this power to give or refuse guarantees, would exercise a great influence on the development and direction of home industry. It would be in a stronger position than otherwise to grant or withhold political favors. It is important to keep in mind that a government would be less likely to think of the broad economic effects of such loans than of their effects in increasing the potential armament program or the economic self-sufficiency of their country in time of war. These considerations, however, would not be the same as those that would lead to the most efficient utilization of world resources. Quite the contrary.

V

I have dwelt at length upon the proposed International Fund and Bank because these are specific proposals that have already been presented in detail. Space unfortunately does not permit an adequate analysis of the proposals for international commodity controls in the postwar period. At the moment of writing only one of these — the Anglo-American oil agreement — has reached the stage of presentation to the public. But indications from many sides have already made it clear that what is being contemplated is a revival and extension on a far greater scale of the type of international commodity controls of the thirties. This seems likely to apply, if the planners have their way, to cotton, wheat, sugar, coffee, tin, beef, tea, rubber, wool, copper, nitrates, cocoa, and quinine. Controls for some of these existed before the war. Many of these peacetime controls have merely been allowed to remain dormant.

The chief controls have proved disastrous failures. Almost invariably they follow the same general pattern. Ostensibly the effort always is merely to "stabilize" the price of the commodity. But in every instance (except in one or two where a temporary control has been imposed by some single powerful governmental buyer) the interests of the producers have been put first. The result in every such instance is that the price is fixed above the level that market conditions justify. To compensate for this, a proportional restriction of output is usually placed on each producer subject to the control. This has several immediately bad effects. It means that total world production is cut. The world's consumers are able to enjoy less of that product than they would have enjoyed without restriction. The world is just that much poorer. Consumers are forced to pay higher prices than otherwise for that product. They have just that much less to spend on other products.

A uniform proportional restriction means, on the one hand, that the efficient low-cost producers are not permitted to turn out all of the output that they can at a low price. It means, on the other hand, that the inefficient high-cost producers are artificially kept in business. This increases the average cost of producing the product. It is being produced less efficiently than otherwise. The inefficient marginal producer thus artificially kept in that line of production continues to tie up land, labor, and capital that could much more profitably and efficiently be devoted to other uses.

If this artificial restriction of output does not take place unsold surpluses of the overpriced commodity continue to pile up until the market for that product finally collapses to a far greater extent than if the control program had never been put into effect. Or producers outside the restriction program, stimulated by the artificial rise in price, expand their own production enormously. This is what happened to the British rubber restriction and the American cotton restriction programs. In either case the collapse of prices finally goes to catastrophic lengths that would never have been reached without the restriction scheme. The plan that started out so bravely to "stabilize" prices and conditions brings incomparably greater *in*stability than the free forces of the market could possibly have brought.

Of course the international commodity controls after the war, we are told, are going to avoid all these errors. This time prices are going to be fixed that are "fair" not only for producers but for consumers. Producing and consuming nations are going to agree on just what these fair prices are, because no one will be unreasonable. Fixed prices will

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necessarily involve "just" allotments and allocations for production and consumption as among nations, but only cynics will anticipate any unseemly international disputes regarding these. Finally, by the greatest miracle of all, this postwar world of super-international controls and coercions is also going to be a world of "free" international trade!

Just what the planners mean by free trade in this connection I am not sure, but we can be sure of some of the things they do not mean. They do not mean the freedom of ordinary people to buy and sell, lend and borrow, at whatever prices or rates they like and wherever they find it most profitable to do so. They do not mean the freedom of the plain citizen to raise as much of a given crop as he wishes, to come and go at will, to settle where he pleases, to take his capital and other belongings with him. They mean, I suspect, the freedom of bureaucrats to settle these matters for him. And they tell him that if he docilely obeys the bureaucrats he will be rewarded by a rise in his living standards. But if the planners succeed in tying up the idea of international cooperation with the idea of increased State domination and control over economic life, the international controls of the future seem only too likely to follow the pattern of the past, in which case the plain man's living standards will decline with his liberties.

Nations Are Economic Partners

Max Lerner

The core problem of the coming economic world pattern is not whether we shall choose between free trade and a policy of restriction. It is rather how to build an economic framework for the nations of the world within which free trade will be related to the problems of a real world, and the efforts to achieve it will take on some perspective and a measure of possibility. It is to see free trade as a consequence rather than as a cause of some degree of economic order in the world. It is to think crucially how that economic order is to be achieved.

If we do not achieve it, and if we bungle this task, then the more formal arrangements for a world security organization will be but a glittering paper construct. Unless there are economic health and economic neighborliness of feeling among the nations of the world, there is very little chance of political health and the avoidance of another war.

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How clear is our present thinking on this score? It is much clearer on the administrative level than on the idea level. That is to say, the practical men and the administrative technicians who have met as international commissions, to discuss the problems of United Nations relief, the need and supply of foodstuffs, the International Monetary Fund and the world bank, and the international regulation of labor standards, have had a surer instinct about the possible and desirable than the commentators who have sat on the side lines and wrung their hands. The attack on the new international economic pattern has come mainly from two sources: from the isolationists and imperialists, who want either American autarchy or an American *imperium*, and who attack any international plans as Henry Wallace idealism and "globaloney"; and from the anti-planning liberal free-traders, who regard any deviation from international *laissez-faire*, to use Hayek's phrase, as "the road to serfdom." Thus on one score

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