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INTERNATIONAL TRADE

By

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READER IN ECONOMICS IN
THE UNIVERSITY OF LONDON



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INTRODUCTION

THE progress which has been made during the last century or so with respect to transport and communications—aided by improvements in industrial technique which have favoured large-scale production and by the development in the joint stock company of a device for separating investment from direct personal control—has resulted in a great increase in the importance of international trade and investment, and has brought the various parts of the world into much closer economic relations. Economists have always welcomed this development of a world economy, regarding it as a natural sequence in the process by which the independent household economy gave place to a town or local economy and the latter to a national economy ; and they have always emphasized the advantages of international trade in opposition to those who favour the ideal of national self-sufficiency. But at the same time the boundaries which separate states must necessarily be more, or less arbitrary from an economic point of view,

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so that there might appear to be nothing in the international character of certain transactions and relations to give them a special significance for economic theory. What, then, is the need for the study of international trade apart from the study of trade in general?

It may be said at once that the formulation of a theory in terms of national units is to a certain extent a task imposed upon the economist, as it were from outside, by the attitude of the public. It might be said that from a strictly scientific point of view the nation is no more significant as a unit than (say) the county or the province. Yet even if this were true, the fact would remain that people are interested in the progress of national wealth and the way in which this is affected by the relations between nations, whilst they are not interested in a similar degree in the position of the smaller units—or for that matter of the larger units. This attitude shapes the questions which are put to the economist and which he must seek to answer. So far as the strictly internal economic relations of a nation are concerned, the ground is already covered by the general propositions of economics which relate to a single isolated community. But the consideration of the effects on each nation of its relations with other nations calls for the adoption of a special

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point of view. Moreover, the lay interest in the latter subject is not merely passive. In practically all countries governments seek to regulate foreign trade in the national interest. This gives rise to questions of national policy on which economists may be expected to advise, and on which they will certainly wish to give advice. Historically, of course, the study of economics largely originated in the discussion of national trade policies.

The political division of the world into states does, however, in some respects modify economic relations and thereby give rise to special problems, apart from any deliberate regulation of international trade.

In the first place, it presents a special obstacle to what economists term "the mobility of the factors of production." As a rule workers will be more willing to move from one region to another within their own country than to migrate to a foreign country, and they are more likely to have knowledge of the opportunities for an advantageous move in the former case. In part, of course, the obstacle to finding employment in foreign countries is one of language; but reluctance to become a foreigner in a strange land is still very widespread, as is also an unwillingness to employ foreigners except for special work.

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Similar considerations apply to capital, although in a less degree. To invest abroad it is not indeed necessary to live abroad, and it has sometimes been suggested that the volume of foreign investment has been unduly large. But generally this movement of capital has resulted from the attraction of relatively high rates of interest or high expectations of profit; at the same rate of interest for the same type of investment the capitalist will usually prefer to employ his money at home, because the uncertainties are fewer. It need hardly be added that the natural obstacles to mobility are often greatly aggravated by the restrictions adopted by the various governments.

These differences between the internal and international mobility of both labour and capital are clearly differences of degree rather than of kind; their significance will be discussed later.

In the second place, each country has usually its separate currency system. Within each country there exists normally one system of units of account in which values and debts are expressed, and one system of means of payment (coins, notes, etc.) by which debts in terms of these units are settled. Moreover, the banking system commonly provides facilities for the making of payments between different parts of the country, either gratu-

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itously or for a nominal charge. Thus within one country the money in which one is paid will serve to buy anything that is for sale anywhere. In international transactions, on the other hand, the money involved is for at least one of the parties foreign money; arrangements have to be provided for converting the money of one country into that of another, and the rate of conversion (rate of exchange) is generally subject to some degree of variation.

It might perhaps be argued that this again is only a difference of degree. Before the War certain groups of countries formed currency unions—*e.g.* the Latin Union (comprising France, Belgium and Switzerland) and the Scandinavian Union: this meant that the members had common currency units (francs and kroner respectively), that certain coins were legal tender throughout the union, and (in the case of the Scandinavian Union) that the banks maintained the exchange at par. Similarly the sterling currency was then common to the United Kingdom, South Africa and Australia. Apart from these special cases, moreover, it may be said that the general adherence to the gold standard virtually resulted in a universal money system, because the units of all the gold standard countries were definitely linked through their con-

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nexion with gold, and gold could always be used as a means of payment between these countries. To complete the argument it might be pointed out that in large countries with undeveloped or decentralized banking systems, the making of inter-local payments is not free from expense and difficulty.

All these points are worth noting, but the argument is hardly convincing. The arrangements by which separate currency systems may be connected, are terminable. The pre-War currency unions were brought to an end by the War and have not been revived; even where countries continue to have currency units with a common name their values may be different—*e.g.* the French, Swiss and Belgian francs. The gold standard was abandoned more or less completely during the War, and, after its general restoration, has again been abandoned by a number of important countries. Thus the possibility of disconnected currency units, free to diverge in value, has always to be taken into account in the theory of international economic relations, whereas in dealing with affairs internal to a particular country we know that there must be a definite limit to the cost of sending money from one part to another. But perhaps the most decisive consideration is that the international gold standard, whilst it is

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in operation, gives rise to problems which do not in fact arise in the internal management of a single currency.¹

It might be said more correctly that the division of the world into regions with different currency systems does not normally affect the way in which the real resources of the world are used and enjoyed, and that therefore it introduces differences in the mechanism of adjustment rather than in the nature of the final adjustments. Accepting this, however, it may be maintained that the mechanism itself is an important subject of study, particularly as it does not always function smoothly.

As another characteristic, it is sometimes said that international trade is predominantly long-distance trade. This is not a feature which is dependent on political divisions, and obviously international trade in the strict sense and long-distance trade are not synonymous. Moreover, although the distance between the parties to a trade is of practical importance, both in so far as it increases the cost of transport and in so far as it implies

¹ There may be several reasons for this. I think the chief is that transferences of purchasing power between countries in the form of gold tend to invoke further changes in the volume of bank credit. This is not the case with internal re-distributions of purchasing power.

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divergent geographical conditions, it hardly presents points of theoretical interest, except in so far as it affects the mobility of capital and labour.

Thus we see that the most definite objective features which distinguish international trade are the special regulation to which it is subject and the special monetary problems which it involves. The latter will provide the main theme for the earlier part of this book. Later chapters will deal with the regulation of international trade, but here the treatment will be different from that of the earlier part, inasmuch as we shall not be concerned to find an explanation of what is or must be, but rather to suggest what should be. Before we reach these questions of policy, however, we shall have to discuss in Chapter V the effects of international trade, with particular reference to its effects on the utilization of the world's real economic resources. Since the regulation of international trade alone is in question, we shall need to discuss these effects irrespective of whether they are peculiar in kind to international as opposed to domestic trade. But this will be the place in which to discuss the bearings of the relative immobility of capital and labour between countries.

CHAPTER I

THE TECHNIQUE OF INTERNATIONAL PAYMENTS

THE payments which have to be made between one country and another as a result of the various transactions of their citizens are usually settled in the last analysis by a process of offsetting or cancellation. This fact used to be held up as rather a peculiarity of international transactions, distinguishing them from dealings within one country, which were supposed generally to be settled by the payment of cash. Nowadays, however, this distinction has lost most of its importance; for within each country the banks provide a system in which book entries are substituted for the transference of cash in payment, and it is through this system that the greater part of the domestic debts is in fact settled.

In the technique of payments between countries an important part is played by the bill of exchange, and some writers represent this instrument as providing in itself the means of cancelling debts between countries. Suppose, for example, that A in France has

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sold goods to B in England to the value of £1,000, and that C in England has sold goods to D in France also valued at £1,000. Then A may draw a bill on B for £1,000, the amount of his claim on B; and it is supposed that he will sell this bill (for francs) to D, who will send it to C in settlement of his debt. C collecting sterling payment on the bill from B on whom it is drawn, in effect B will pay C instead of paying A, and D will pay A instead of paying C. Thus no payment between France and England is necessary.

An example such as this serves to reveal the essentials of the process of offsetting international indebtedness, but somewhat falsifies the actual business procedure. In practice a single bill is seldom used to settle two transactions. For one thing the sums involved in two transactions would rarely match precisely. Another difficulty would be that the bill drawn by the exporter is not generally marketable until it has been "accepted" or endorsed by the importer, and considerable time would be wasted in sending it from the exporter to the importer and then back again to the exporter. Yet further complications are introduced by the period of credit commonly allowed in foreign trade. The exporter draws a bill payable (say) 90 days after sight: he wishes to realize money on the bill in his own coun-

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try at once, but the importers in this country will only wish to purchase remittances to their foreign creditors when their debts are due for immediate payment.

These difficulties are overcome by the mediation of the banks and exchange dealers. The French exporter, having drawn a bill on his English customer, hands it over, together with the documents which give control over the goods in transit, to his bank, which either purchases (discounts) it outright or makes an advance to the exporter of a certain proportion of its value. In either case the current rate of exchange determines what the exporter will receive for this foreign bill in terms of francs. The bank then sends the bill and the documents to its correspondent bank in England; the correspondent gives the documents to the importer in return for his acceptance of the bill; and finally, the accepted bill is probably discounted in the London bill market. As a result of this chain of transactions, the exporter's bank has paid out money in France, but is credited with a balance with its London correspondent. But this same bank may have other customers who are importing from England, or who have for other reasons to make payments to that country. Let us suppose that some of these customers are importers who have arranged

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for bills drawn by their exporters to be accepted on their behalf by London Accepting Houses, and who will therefore have to remit money to London to cover these acceptances on maturity. By selling drafts on London to these, our French bank will be able to convert its balance in London into funds in France, thereby restoring its original position. Again no payment will be necessary between the two countries, the debits and credits being offset between the French bank and its correspondent.

It will rarely happen, of course, that any one French bank will be able to balance precisely the sterling claims payable and receivable by its customers. Usually the business of such a bank with its customers will result at any time in a certain difference one way or the other, an excess either of the sterling claims offered or of the sterling drafts demanded. To meet this, recourse may be had to the Foreign Exchange Market, in which the banks and other exchange dealers come together to exchange foreign balances for the national currency. Such markets are found in the leading financial centres, and it is here that the rates of exchange are fixed which form the basis of the rates applied by the banks in their dealings with their customers.

At this point a certain complication must be

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dealt with. In the cases considered above, we have supposed the payments due on both sides between England and France to be fixed in terms of sterling. Now it also happens that payments are due in both directions which are fixed in terms of francs ; and these are dealt with by the English banks and the London Foreign Exchange Market in precisely the same way as were the sterling payments by the French institutions in the instances just examined. But the difficulty may suggest itself that the franc-sterling exchange rate as fixed in London may not agree with the rate fixed in the Paris market—that, for instance, so far as debts fixed in francs are concerned the balance might tend to be in favour of England, whilst with respect to sterling debts there might be an excess due to France. It may be shown, however, that such a situation would be corrected almost immediately. Professional operators would find it profitable to buy francs for sterling in London and sell francs for sterling in Paris ; and these transactions would even out demand and supply at the two centres and bring the exchange rates into agreement. In fact, so far as dealings in francs against sterling are concerned, the markets in London and Paris may be considered as virtually one.

In this market, then, the banks seek to

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make good their excess or deficiency of balances in the foreign centre after meeting their customers' requirements. Some having an excess and some a deficiency, demand and supply will match to a certain extent. But it is not to be expected that a perfect balance will be attained in this way, for the payments due between any two countries rarely balance. On the contrary, in the most normal times there is usually a marked excess due in one direction or the other. To meet this difference, if it appears to be temporary, the banks in one country may borrow from those of the other, or (what amounts to the same thing) the banks of the creditor country may be induced to increase the balances they hold in the debtor country ; or, between gold standard countries, gold movements may take place. But before resort to these means of establishing a balance, advantage will be taken of another possibility.

While country A may owe on balance to country B, other countries C and D, etc., may owe on balance to A ; and some of these may be owed on balance by B. This gives the possibility that A may meet her balance of indebtedness towards B by ceding her surplus claims on C or D, thereby enabling B to cancel in whole or part her indebtedness to that country. If what each country has to pay to the

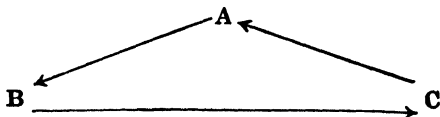
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other countries collectively were always just equal to what these other countries together owed to it, if, that is to say, the total balance of payments of each country against the rest of the world were always square, it should be clear that all international indebtedness could be cancelled by this wider process of offsetting, however great the differences in the payments due between any two countries. How far in fact the payments between one country and the rest of the world do balance, and how this result is brought about, are questions which will be considered in the next chapter. Here it need only be said that there is a tendency to establish such a balance, and that at any rate a much closer approach to a balance is attained in the relation between one country and the rest of the world than in the relations between one country and another country.

Although this wider process of offsetting may be arranged between the banks concerned in each country with financing the foreign trade of their customers, in practice it is greatly assisted by the operations of specialist exchange dealers, who are on the look out for more casual opportunities of making a profit in the exchange market. Let us suppose that we have simply three countries, A, B and C, and that A owes on balance to B, B to C, and C

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to A. Thus (the arrows indicating the direction of net indebtedness) :



Obviously the process of direct offsetting between each pair of countries will leave unsettled differences, and the existence of these, meaning an excess demand for remittances in one direction, will tend to lower the exchange value of A's currency in terms of B's, of B's currency in terms of C's, and of C's currency in terms of A's. But such a movement of exchange rates will make it profitable for exchange dealers to intervene. Buying C's currency in A (where it is cheap), they will sell it in B (where it is dear) and thus obtain a command over B's currency to sell in A at a profit; and in doing this they will provide the traders with the remittances which they require in each country and level up the exchange rates again. Of course this arbitrage business, as it is called, finds much more scope in the real world, in which there are many countries and the direction of indebtedness shifts from day to day, than it would in the simple case we are imagining.

But the whole process might be greatly

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simplified if all the payments, to be made between the three countries were fixed in terms of the currency of one of them, say A's currency. That is to say, if not only the payments in both directions between A and B, and between A and C, were due in A's currency, but also all payments between B and C. Then A, or its leading financial centre, would act as a clearing-house for the other countries, and each of these would only have to settle with A for any net balance in its relations with the outside world. This system would involve a certain disadvantage for the traders in countries other than A, inasmuch as they would have to do their foreign business in terms of a foreign currency; but this disadvantage must always exist for at least one of the parties to an international contract, and the general advantage of the system would be that it would eliminate dependence on exchange operators, who naturally only intervene when they see an opportunity of making a profit for themselves.

Such a scheme for concentrating all international payments on one centre has never been adopted, but some approach to it can be seen in the use of sterling as an international currency before the War. The British currency was reputed to be anchored with peculiar fastness to gold, and was familiar through-

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out the world in consequence of our widespread trade. Moreover, the London Money Market offered exceptional facilities for the financing of international trade: her merchant bankers were ready to accept bills on behalf of foreign merchants on the most reasonable terms, and, once accepted, these bills were easily discounted in her well-developed bill market. These advantages, allied with the general advantage of concentrating payments, as explained above, resulted in the use of sterling not only in most contracts between Britain and other countries, but also in many contracts between other countries. For example, most of the trade of the South American and Far Eastern countries was on a sterling basis.

The international importance of the London Money Market naturally suffered severely from the effects of the War and of the depreciation of sterling immediately afterwards. With the restoration of the gold standard at the pre-War parity in 1925, considerable hopes were entertained for the recovery of London's former international position. In some measure these were realized, but by no means completely. New York and Amsterdam had both acquired a share in the business of international finance before 1925, from which they could not readily be ousted; and later Paris sought to enter the field as a further com-

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petitor. A year ago, when most of this chapter was first written, it seemed safe to suggest that it was unlikely that any of these rivals would succeed to the predominance once enjoyed by London, but that it was also unlikely that they would retire from the competition in the interest of a more complete centralization of international payments. With the breakdown of the gold standard as a world system in the autumn of 1931, the situation has again changed, and in the present confusion and uncertainty any prophecy as to the future monetary arrangements of the world would be a rash guess.¹

¹ When there is a risk of an appreciable variation in the exchange rate before a transaction involving a foreign payment can be completed, both merchants and bankers endeavour to safeguard their position by entering into forward contracts in foreign exchange. Limitations of space preclude a description of these further transactions here. They do not alter the character of the offsetting process described above.

CHAPTER II

FOREIGN EXCHANGE RATES AND THE BALANCE OF PAYMENTS

THE rate of exchange in its pure form is the rate at which command over the currency of one country is exchanged for command over the currency of another country.

In the preceding chapter we have seen how exchange rates are applied in the course of settling international transactions, but the rates actually quoted or applied almost invariably allow for other elements over and above the simple exchange of one currency for another. For example, when a merchant draws a bill in foreign currency upon his customer abroad and sells this bill to his bank for his own currency, the bank does more than give national currency in return for a claim to foreign currency. Firstly, the bank may assume a certain risk that the bill will not be properly met ; usually the bank secures itself against the risk of eventual loss, but the risk of inconvenience and delay in recovering its money may remain. Secondly, it assumes

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certain expenses in connexion with the transmission of the bill to the acceptor and the handling of the documents. Thirdly, it advances the value of the bill for the period during which it is being sent to the acceptor. Fourthly, the bill being usually payable only after a certain interval from acceptance (say 90 days after sight), the bank has either to advance its value for this further period or to have it discounted abroad. All these points are taken into account in fixing the rate at which the bill will be bought. In the case of the purchase of a foreign cheque, the discount element is absent and the incidental expenses of the bank are less—hence the difference between the cheque rate and the rate for long bills. But the loss of interest during the period of transmission still counts for something. We come nearest to a pure exchange rate in the rate for Telegraphic Transfers, in which the central exchange markets now deal chiefly. In this form of transaction money is paid over in both centres on the same day, usually the day after that on which the contract is made, and the only incidental element is the cost to the seller of notifying his foreign correspondent of the sum to be paid out abroad. If we take the mean of the T.T. rates quoted with respect to one another in two centres, we should arrive at

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the current price of one currency in terms of the other.

This price, like any other, is the outcome of the relations of demand and supply at the moment. Now the demand and supply of one currency in terms of another originate most obviously in the payments which have to be made between those using the respective currencies. But it should be clear from the preceding chapter that claims on a particular foreign currency can also be of value as a means of settling debts in terms of another foreign currency. Thus we cannot isolate the payments to be made between two currencies and relate these to the rate of exchange between them. We have to consider for each country the payments between it and the rest of the world and to relate these payments to the exchange value of its currency against other currencies in general. Or, if we wish to study the influences on a particular exchange rate, we have to consider the total payment relations of both the countries concerned.

Payments due between countries may be classified as follows, in accordance with the nature of the transactions which occasion them.

Payments for Goods and Services.

1. Payments due in respect of goods currently rendered and received—in other words,

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commodity exports and imports. These are commonly said to constitute a country's *visible trade*, because the values are officially recorded and published by the customs authorities.

Strictly speaking, payments are due at any time not in respect of the imports and exports then taking place, but in respect of those which have taken place a little earlier; for, as has been mentioned, it is usual to allow credit for a certain period.

2. Payments due in respect of services rendered from one country to another.

These services may be of various kinds. Perhaps the most important is the carriage of goods in ships of one country on behalf of another. In the statistics of foreign trade it is usual to price the goods at their value on crossing the frontier, *i.e.* to take the f.o.b. value of exports and the c.i.f. value of imports. The difference between the f.o.b.¹ and c.i.f.² value of a consignment is due to the country whose ships—or for that matter, railways—carry the goods, after allowing what is due to the country whose insurance companies have insured them. It should be noticed, however, that when a country carries its imports in its own ships, this method of valu-

¹ "Free on board."

² "Cost, insurance, freight."

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ing imports overstates its foreign indebtedness. In such a case, in striking the balance of the country's indebtedness one should either correct the value of the imports or else compensate the overcharge by crediting the country with the value of this shipping service, as though it were performed on behalf of foreigners.

The insurance of freight has been mentioned incidentally above. Insurance companies may also issue policies to people abroad for many other kinds of insurance contracts, and the periodical premiums due are another kind of payment for service. Countries which have an entrepôt trade earn trading commissions and profits from abroad, whilst the presence of an international financial centre in a country similarly brings in financial commissions and profits.

Under all these heads considerable sums are generally due to Britain on balance.

3. Payments due in respect of goods and services supplied to travellers and tourists in foreign countries. Catering for tourists is of course an important industry of many continental countries.

One-sided Transfers of Wealth.

4. The giving and receiving of foreign loans and investments. The investment of capital

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abroad is frequently spoken of as the Export of Capital. This phrase is somewhat misleading, however, for whereas an export normally occasions a payment to the exporting country, it is the investing or lending country which is due to make the payment to the borrowing country. Hence if the transaction is to be described in terms of exports and imports, it would be better to speak of the Import of Securities.

Foreign investment may suggest particularly investment in long-term securities—government loans and the debentures and shares of companies. But short-term loans, including the movement of balances from one financial centre to another, are equally the occasion of international payments.

The repayment of a loan naturally occasions a payment in the opposite direction, from borrower to lender.

5. The payment of interest and dividends on foreign investments.

6. Other debt payments. Here we may include particularly war indemnities (Reparations).

7. Gifts sent from one country to another. This apparently insignificant item is important in some cases. Considerable sums are sent home annually to Italy by Italians who have emigrated to South America. The gifts of

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American charities to Europe since the War must also amount to an appreciable sum.

In place of the main division into payments in respect of goods and services and one-sided payments, it is for some purposes more important to make a distinction between payments in respect of current or income transactions and payments in respect of capital transactions. In this arrangement, which is the one usually adopted in classified statements of international payments, interest payments and gifts appear with payments for goods and services in the first division. (Reparations and War debt payments usually appear here also, although in so far as they contain amortization payments they belong strictly to capital transactions.) The significance of this division is that if a country has a credit balance in respect of its current international transactions for any period, it is building up a creditor position (or reducing a debtor position) in relation to the rest of the world—and contrariwise, if it has a debit balance on current transactions. But it must be remembered that changes in a country's position as an international creditor or debtor do not necessarily mean a corresponding change in that country's wealth. A country, like an individual or a business, often finds that it pays to borrow.

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The Economic and Financial Organization of the League of Nations collects and publishes statistics of the "Balances of International Payments" of 29 countries. For this purpose it has drawn up a standard form of statement, and, although few countries have adopted this in full, it is worth reproducing for its detailed classification of the various items.¹

¹ Memorandum on International Trade and Balances of Payments 1927-9. Vol. II, pp. 7-10.

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Contractions used (Credit and Debit Items)	Full Wording of the Items given in the First Column	
	Credit Items	Debit Items
CURRENT ITEMS		
I. <i>Merchandise</i>		
1. Merchandise	Merchandise, including silver bullion and coins other than gold, exported (according to trade returns) Adjustment of 1 in order to arrive at the commercial value f.o.b. Contraband exports	Merchandise, including silver bullion and coins other than gold, imported (according to trade returns) Adjustment of 1 in order to arrive at the commercial value c.i.f. Contraband imports
2. Adjustment for wrong valuation		
3. Contraband		
II. <i>Gold coin and bullion</i>		
4. Gold coin and bullion	Gold bullion and gold specie exported (according to trade returns) Adjustment of 4 in order to arrive at the commercial value f.o.b.	Gold bullion and gold specie imported (according to trade returns) Adjustment of 4 in order to arrive at the commercial value c.i.f.
5. Adjustment for wrong valuation		
III. <i>Interest and dividends</i>		
6. Interest on inter-governmental debts	Interest received on intergovernmental debts n.e.i. (interallied debts, etc.)	Interest paid on intergovernmental debts n.e.i. (interallied debts, etc.)

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7. Interest on other public debts	Interest received on other foreign government and municipal loans	Interest paid on other Government and municipal foreign debt
8. Other interest and dividends on long-term capital	Other interest and dividends received from long-term capital investments abroad	Interest and dividends paid on foreign long-term capital invested in the country
IV. Other current items		
9. Interest on short-term capital	Interest received from short-term capital invested abroad	Interest paid on foreign short-term capital invested in the country
10. Shipping :	Income of national ships on account of all foreign traffic ¹ :	Payments to foreign ships on account of traffic between domestic ports :
(a) ordinary freight	(a) ordinary freights	(a) ordinary freights
(b) charter money	(b) charter money	(b) charter money
(c) passage money	(c) passage money	(c) passage money
11. Port fees	Port receipts from foreign shipping in national ports	Port expenses incurred by national shipping in foreign ports
12. Other transport fees	Transport and other charges received for foreign goods transhipped or in transit (if not included in Group I)	Transport payments to foreign carriers, n.e.i.
13. Commissions, insurance, brokerage	Commissions, insurance, brokerage and similar receipts, n.e.i.	Commissions, insurance, brokerage and similar payments, n.e.i.

¹ Foreign shipping traffic here means all traffic other than that between domestic ports. Maritime freight on imported goods, which is included in Group I of imports, amounted to approximately during the year. Of this amount, about were paid to national ships, and included on the credit side against Item 10.

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Contractions used (Credit and Debit Items)	Full Wording of the Items given in the First Column	
	Credit Items	Debit Items
CURRENT ITEMS (<i>continued</i>)		
14. Post, telegraph and telephone	Post, telegraph and telephone earnings, n.e.i.	Post, telegraph and telephone payments, n.e.i.
15. Immigrants' and emigrants' funds	Funds brought in by immigrants and returned emigrants	Funds taken out by emigrants and returning immigrants
16. Immigrants' and emigrants' remittances	Immigrants' remittances and money gifts from abroad, n.e.i.	Immigrants' remittances and money gifts sent abroad, n.e.i.
17. Tourists' expenditure	Receipts from foreign tourists and travellers	Expenditure abroad by national tourists and travellers
18. Diplomatic and similar expenditure	Diplomatic, consular and similar expenditure in the country	Diplomatic, consular and similar expenditure abroad
19. Miscellaneous personal services	Receipts for services rendered in the country for "persons" domiciled abroad, n.e.i.	Payments for services rendered abroad for "persons" domiciled in the country, n.e.i.
20. Reparations in cash	Government receipts in cash on account of reparation payments : (a) amortization (b) interest	Government payments in cash on account of reparations : (a) amortization (b) interest
21. Counter-value of reparations in kind	Counter-value of reparation receipts in kind, included in merchandise imports above	Counter-value of reparation deliveries in kind, included in merchandise exports above

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22. Other Government receipts and exp.	Government receipts from abroad, n.e.i.	Government expenditure abroad, n.e.i.
23. Other items	Other current items	Other current items
CAPITAL ITEMS		
I. Long-term operations		
1. Amortization : (a) of intergovernmental debts	Receipts on account of amortization of intergovernmental debts, n.e.i. (inter-allied debts; etc.)	Payments on account of amortization of intergovernmental debts, n.e.i. (inter-allied debts, etc.)
(b) of other public debts	Receipts on account of amortization of other foreign government and municipal loans	Payments on account of amortization of other Government and municipal foreign debt
(c) of other debts	Receipts on account of amortization of other loans	Payments on account of amortization of other loans raised abroad
2. Purchases and sales : (a) of real estate abroad	Real estate (a) abroad	Real estate (a) abroad
(b) of real estate in the country	(b) in the country sold abroad	(b) in the country purchased from foreigners abroad
(c) of domestic securities	Existing domestic securities sold abroad	Repurchase of national securities formerly held abroad
(d) of foreign securities	Foreign securities resold abroad	Purchase of existing foreign securities issued abroad

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Contractions used (Credit and Debit Items)	Full Wording of the Items given in the First Column	
	Credit Items	Debit Items
CAPITAL ITEMS (continued)		
3. New capital issues :		New foreign capital issues sub- scribed in the country :
(a) Government and municipal	(a) Government and mun- icipal loans	(a) on account of foreign government and mun- icipal loans
(b) other	(b) other loans	(b) other capital issues
4. Participation in new capital issues	Sale of new domestic securities on account of foreign partici- pation in domestic capital issues	Participation of domestic capital in foreign capital issues
5. Other long-term invest- ments	Other foreign long-term capital invested in the country	Other long-term capital invest- ments made abroad
II. <i>Short-term opera- tions</i>		
6. Change in short-term debts	Net increase in foreign short- term debts on account of credits raised and repaid	Net decrease in foreign short- term debts on account of credits raised and repaid
7. Change in short-term assets	Net decrease in foreign floating assets on account of short- term credits granted and re- paid	Net increase in foreign floating assets on account of short- term credits granted and re- paid

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The British Government publishes annually a statement which is much more summary, and omits capital transactions altogether. Only the net balance is given against each heading.

Balances of Credits and Debits in the Transactions (Other than the Lending and Repayment of Capital) between the United Kingdom and All Other Countries.¹

Particulars	1929	1930	1931
Excess of imports of merchandise and silver bullion and specie . .	In million £'s		
	381	386	411
Estimated excess of Government receipts from overseas ²	24	19	16
Estimated net national shipping income ³	130	105	80
Estimated net income from overseas investments	250	220	165
Estimated net receipts from short interest and commissions	65	55	30
Estimated net receipts from other sources	15	15	10
Total	484	414	301
Estimated total credit or debit balance in items specified above . .	+ 103	+ 28	- 110
Excess of exports (+) or imports (-) of gold bullion and specie . . .	+ 15	- 5	+ 35

¹ Board of Trade Journal. Feb. 18, 1932, p. 219.

² Including some items on loan accounts.

³ Including disbursements by foreign ships in British ports.

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The term "balance of payments" is sometimes used, as in the title of the League of Nations publication referred to above, to mean the whole scheme of debits and credits between one country and others. It is also used, however, to denote the relationship between the totals of the debit and credit sides. Thus the balance is said to be "favourable," "unfavourable" or "even," according as there is supposed to be a surplus of credits, or of debits, or equality between the two. (It may also be used, in strict accordance with bookkeeping practice, to mean the absolute difference between the two sides of the account. More usually, however, this is referred to as the "balance of indebtedness.")

It is in the second sense that the term is used when it is said that the balance of payments determines the exchange value of a country's currency—its value in terms of other currencies in general, as registered in the quotations of the foreign exchange market. A favourable balance is said to cause the exchange rate to rise, an unfavourable balance to cause it to fall.

As a working theory of the foreign exchanges the Balance of Payments theory may be found sufficiently useful so long as we are chiefly concerned with countries on the gold standard. Between gold standard currencies

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there exists a definite gold parity, or mint par of exchange, based on the relation between the prices fixed for gold in each currency. Whatever the state of the balance of payments the actual exchange rates can only move a limited distance in either direction from these parities because a point will soon be reached—the Import or Export Specie Point—beyond which it will pay to transmit gold rather than to purchase exchange remittances. In the last resort, therefore, gold will be used to settle differences owing between these countries, and the movement of the exchange rates to the specie point will be explained by the favourable or unfavourable balance of payments apart from the gold movements. But even here the theory is not entirely satisfactory, since it does not explain the small movements of exchange rates when a country is neither gaining nor losing gold. (Assuming for the sake of simplicity that there are only two countries, according to the Balance of Payments theory the exchange rate should either be at par—when the balance is even—or at the export or import point—when there is a difference to be settled by a gold shipment. The existence of an intermediate rate seems impossible.) The deficiencies of this theory are most marked, however, when we seek to apply it to the case of a currency

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which is not on the gold standard, such as an inconvertible paper currency. In terms of such a currency the price of gold is variable, and gold movements, if permitted, have in these circumstances only the same significance as movements of other commodities. The problem then arises as to whether in drawing up the balance of payments we are to include changes in short-term international indebtedness. As Professor Aftalion has shown, we are faced with a dilemma. If we include these changes, then the balance of payments must always be even, since what a country cannot pay it must owe for the time being—which is equivalent to the receipt of a temporary loan. If, on the other hand, we omit these changes, we ignore such factors as the movements of short-term balances and the receipt of short-term credits, which do certainly in practice have an important influence on the rate of exchange.

The fundamental flaw in the Balance of Payments theory, as stated above, is that it represents the balance of payments as itself entirely independent of the rates of exchange. Were this the case, the exchange value of a gold standard currency would depreciate to the gold export point immediately the balance of payments became adverse, and in the like circumstances the exchange value of a paper

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currency would apparently fall to zero. The fact is, of course, that the fall in the exchange value of the currency would influence international transactions in a manner tending to restore equilibrium in the balance of payments. At the lower exchange value, goods produced in the country would become cheaper to foreign purchasers, whilst foreign goods would become dearer to home purchasers. Thus exports would be encouraged and imports discouraged. The restoration of equilibrium would hardly be accomplished immediately. But in the meantime the exchange would be supported by foreigners who, in the anticipation of its recovery, would be prepared to convert money holdings abroad temporarily into the depreciating currency—thereby granting the country in effect a short-term loan.

Taking account of these reactions of items in the balance of payments to movements in exchange rates, we may restate the Balance of Payments theory in a more satisfactory form by saying that the rates of exchange prevailing are those which bring the balance of payments into equilibrium. It will be understood, of course, that as between gold standard currencies, these rates cannot normally lie outside the so-called specie points, because, once these are reached, equilibrium will be established by gold shipments.

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Thus stated, the theory gives full weight to the fact which impresses the practical banker—namely, that any change in the items constituting the balance of payments is usually reflected in the exchange rates. For such a disturbance in the previously existing position will demand adjustment to a new position of equilibrium. But at the same time it is in line with the general theory of value, in which supply and demand are conceived not as quantities rigidly fixed, but as quantities varying with the terms of exchange.

CHAPTER III

THE THEORY OF INTERNATIONAL PRICE EQUILIBRIUM

THE theory of foreign exchange rates reached at the end of the last chapter is satisfactory so far as it goes, but by no means complete. It is essentially a market-price theory, in the sense that it indicates the constituents of demand and supply, and shows how an immediate equilibrium is established between the two sets of forces. It falls short of a complete theory in that it fails to reveal the conditions upon which a durable equilibrium depends. In the case of currencies not on the gold standard we have as yet no clue as to what exchange rates are *normal* for any set of conditions; and whilst in the case of gold standard currencies we know that the movement of the exchange rates is limited by the possibility of transmitting gold, we have yet to discover the circumstances which determine when such gold movements are necessary and when accounts can be balanced without them. The importance of this latter question is

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obvious, for a country which wishes to remain on the gold standard cannot go on shipping gold indefinitely.

These questions were discussed with great insight by the earlier English economists in the first part of the last century. During the later period down to the outbreak of the Great War the comparatively smooth working of the gold standard system caused them to be somewhat neglected; but they again assumed urgent importance with the dislocation of that system after 1914.

The first important attempt of recent times to state the principle which regulates the movement of exchange rates, when they are no longer held within limits by the gold standard, was made by Professor Gustav Cassel in his famous theory of Purchasing Power Parity. The essence of this theory is that exchange rates should normally reflect the relation between the internal purchasing powers of the various national currency units. When, for example, francs are exchanged for sterling through the medium of the exchange market, what is really being exchanged is a certain command over goods and services in France for a certain command over goods and services in England; and for this exchange to be satisfactory to both sides there must be some kind of equality between the two "commands" or

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purchasing powers. This implies that the rate of exchange must be in correspondence with the relation between the scale of franc prices in France and the scale of sterling prices in England. Naturally, the rates of exchange will not equalize all prices of individual commodities ; for in that case there would be no object in continuing trade between the countries. But at the *normal* rates of exchange these differences in particular prices should average out. Temporarily the market rates of exchange may diverge from the normal rates, thereby either over-valuing or under-valuing a particular currency. But in the one case there will be an abnormal stimulus to imports and check to exports, in the other an abnormal stimulus to exports and a check to imports. In either case the position will be unstable, and the disturbance of the balance of payments will bring the exchange rates back to the normal.

This is an outline of the purchasing power parity theory in its simplest form. Rediscovered rather than invented by Professor Cassel, it was expounded by him with great force and lucidity during the period of inconvertible paper currencies and fluctuating exchange rates from 1914 to 1924 ; and it performed admirable service both in showing the irrelevance of the pre-War gold parities to the exist-

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ing situation and in providing in substitution a more appropriate conception of normal exchange rates.

In its essence, however, the theory does not apply exclusively to paper currencies with variable exchange rates. It also implies that when exchange rates are fixed, prices will be adjusted in each country to give substantial equality at those rates of exchange. If, as between countries on the gold standard, gold prices are not at the same level, the balance of payments of the several countries will be affected and, in the first instance, the rates of exchange between them. The exchange rates can in this case only move to the "gold points," when gold will pass between the countries to settle the differences owing. But the transference of gold should bring about an adjustment of prices towards equality by causing, directly or indirectly, a contraction of currency in the debtor countries and an expansion of currency in the creditor countries. The effect of the gold movements on currency and prices might of course be impeded by the action of the currency authorities, but in that case some of the countries would sooner or later have to abandon the gold standard, and the exchange value of their currencies would then be free to depreciate. Thus enlarged, the theory is seen to be a theory of the equaliza-

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tion of prices internationally, variations in exchange rates and adjustments of prices as result of gold movements being' alternative means of establishing the normal relation of equality.

It is clear that there must be a connexion between the prices prevailing in the various countries and the rates of exchange between their currencies. Perhaps this can be seen most readily by reflecting that other commodities as well as gold can be sent abroad to settle an adverse balance. The peculiarity of gold which causes it to be used so extensively for this purpose is that under the gold standard arrangement it has a fixed price in each currency, so that a definite movement of the exchange rate from gold parity practically always makes it worth while to ship gold from one country to the other. The prices of the other commodities not being fixed, one cannot predict that it will pay to send them from one country to another at any particular rate of exchange. But at any time their prices in terms of the various currencies may be taken as given, and then one may say that for each class of goods, not physically immovable, there is a definite rate of exchange at which it becomes exportable from one country to the other. Hence the position of the rate of exchange which equilibrates the balance of pay-

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ments depend's, in the absence of the gold standard arrangement, on the scales of prices in the countries concerned. Alternatively, if we take the case in which exchange rates are fixed in narrow limits by adherence to the gold standard, there is for each commodity a relationship of prices as between one country and another at which it becomes more advantageous to export that commodity than to export gold; and thus there must be a scale of prices for each country which gives equilibrium in its balance of payments without gold movements, given the exchange parity and given the scales of prices elsewhere. But it is one thing to demonstrate that there is a connexion between the relation of prices in terms of the several currencies and the exchange value of those currencies, and another thing to show that that connexion is such that, taking some average, prices converted at the rate of exchange must normally be equal.

Let us consider what prices or price levels they are which are supposed to be equalized.

On this point the theory may be interpreted in two ways. Firstly, it may be taken to refer exclusively to the prices of goods which enter into international trade as imports and exports. Secondly, it may be taken to refer to prices more generally, including particularly the prices of goods and services which are only

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traded within each country. Very broadly, the distinction is between prices as measured by a wholesale index number, and prices as measured by a cost of living index number. On the second interpretation account may also be taken of the scale of incomes earned in production. The rates at which these incomes are earned are in fact prices of a special kind—prices of the factors of production; and they are especially important because, given the conditions of efficiency, they determine the money costs of producing goods both for the home and the foreign market.

The former interpretation may appear more natural, because exchange rates arise in connexion with international transactions. If dealings in foreign exchange are to be regarded as the exchange of purchasing power in one country for purchasing in another country, it would seem that the purchasing power in question should mean power to purchase exportable goods. Furthermore, it can be shown that the goods which enter freely into international trade do tend to have a uniform price over a large part of the world, when allowance is made for transport costs and tariff barriers.

Yet the theory does not prove to be very satisfactory when interpreted in this way. In the first place, it presupposes a fairly clear

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division between the goods which enter into international trade and those which do not. Now at any time this distinction is rather blurred by the fact that any goods and services may become virtual exports by being consumed by foreign visitors. But a more important point is that the line of division is a shifting one and that its position may be influenced by changes in the exchange rates (in the case of paper currencies) or by changes in the relative scale of prices and costs (in the case of gold standard currencies). Thus, in taking the division as given, we are leaving out of view an essential phase of the process of international adjustment. Moreover, as Mr. Keynes has shown, if we look merely at the goods which almost invariably enter into foreign trade, the adaptation of their price in each country to the world level takes place so automatically and instantaneously, that its accomplishment signifies little as to the fundamental adjustments which are necessary from time to time. In the case of paper currencies, for example, the prices of these commodities seem to follow rather than to determine the movements of the exchange rates.

We turn therefore to the second interpretation of the theory, which takes account of a wider range of prices in each country. Here we meet with the technical difficulty that

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people spend their money differently in different countries, so that the basis for complete and accurate comparisons of prices is lacking. Such broad comparisons as can be made, however, indicate that the general range of prices varies very much from one country to another, some countries being for long periods relatively cheap to live in, others relatively dear. And this conclusion is confirmed by comparisons of the scales of money incomes.

It would thus appear that the theory which we are examining is in one sense an empty truism and in the other sense not true at all.

It can, however, be restated in yet another way to meet these objections. It may be conceded that at any time there will be certain differences in the range of prices as between one country and another. If at this date a normal condition of equilibrium exists, these differences may be termed appropriate differences in the range of prices. Then comparing the position at this first date with that at a later date, it may be said that, other things being the same (*i.e.* the conditions which determine the appropriate differences being unchanged), the movements of the rates of exchange should reflect the relative change in general prices over the intervening period. That is to say, if prices have risen more in one country than in another, other things

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being equal, the exchange value of its currency should be lower in proportion.

Professor Cassel has used the theory chiefly in this comparative form. Put in this way, it is certainly true and can, as Cassel has shown, be of value. But a complete theory must not assume that a number of conditions remain unchanged, without explaining what those conditions are and how they would affect the outcome if they did change. We must accordingly inquire into the circumstances which affect the appropriate relations between the price and income structures of different countries. It will be convenient to assume the existence of a state of 'stable equilibrium' to begin with, and to consider what changes may cause this state of equilibrium to be displaced by 'another.' It is not assumed, it may be noted, that in the initial position the level of prices and incomes is uniform from country to country.

International price equilibrium may be disturbed then by changes of the following types.

1. Changes in international demand, *i.e.* in the real demand of one country for the exports of another, resulting in changes in the terms on which their products are exchanged.

For the sake of simplicity, let us suppose that there are just two countries, A and B, each producing one commodity for export,

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respectively x and y . Let us suppose that in the initial state of equilibrium one unit of x exchanges for one unit of y . • (The units need not be the same—it may be one yard of x for one ton of y .) It is not suggested that the commodities are directly bartered; our assumption is that a unit of x delivered in country B sells for a sum just sufficient to pay for a unit of y delivered in A. Let the cost of the unit of x in terms of A's currency be a ; similarly let the cost of a unit of y in B's currency be b ; then it follows that a equals b in exchange value.¹

Now suppose that there is a sharp decline in A's demand for the commodity y . This will involve a readjustment of the value of y in terms of x ; let us say that the terms of commodity exchange will finally settle down at the rate of one unit of x for two units of y . Given this change in the real or commodity terms of trade, what will be the monetary adjustments called for?

We shall expect the form of the adjustments to differ according as the currencies are supposed to be independent currencies

¹ To be strictly accurate, this result only follows if the costs of transporting x to B and y to A are equal. In order to avoid the necessity of considering this factor, we shall assume for the present, that transport costs represent an equal and fixed proportion of the value of each country's exports.

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with variable exchange rates, or gold standard currencies linked together by exchange rates fixed within narrow limits. But before we can proceed to work out a solution for either case, we have to introduce certain further assumptions, in order to render the problem determinate. These are, firstly, that in each country the remuneration of the factors of production engaged in producing for export will be the same as that earned by the same factors in producing for the home market; and secondly, that any change which the process of adjustment may involve in the scale of production of the export industries will not affect the cost of production per unit in terms of the factors of production of the producing country. We can reconsider the validity of these assumptions later.

Taking now first the case in which A and B have independent currencies, we may suppose the general level of incomes earned in production in each country to remain unchanged. This being so, there is no reason, on the above assumptions, why the cost of a unit of x in A's currency should change from the original price a , nor why a cost of a unit of y in B's currency should not still be b . But if x is to be worth $2y$, this must then mean that a is worth $2b$. The falling off in A's demand for B's product will cause the exchange value of

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B's currency to depreciate, and this is the point to which it must depreciate, given the change in the commodity terms of trade and given the other assumptions stated.

In the other case, when the currencies of A and B are both on the gold standard, we may consider the rate of exchange to be fixed at a equals b . For one unit of x to become worth two units of y , therefore, the price of x or y or both must change in terms of the money of the producing country. But on the assumption that the factors of production are equally remunerated in all employments in the same country, the change in the prices of x or y will involve corresponding changes in the prices of the goods produced in each country for domestic consumption—in the general level of incomes and domestic prices in each country. Such changes will probably be initiated by movements of gold from B to A, occasioned by the temporary deficit in B's balance of payment. If we suppose that A is very much larger than B, if for example A represents the world in general outside the one country B, practically the whole of the adjustment may be made by changing the level of prices and incomes in B, whilst prices and incomes in A remain nearly unchanged. In that case domestic prices and incomes in B would be almost halved.

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It will be noticed that whether the final adjustment is brought about by a movement in the exchange rates or by movements in price and income structures, the prices of the international goods x and y , converted at the rate of exchange, will be the same in both countries, when allowance is made for the cost of transport. It is in the other prices and in the scales of incomes earned in production, that the changed relation appears. But the change here is not accidental or irrelevant, as some versions of the purchasing power parity theory would suggest. It is an essential part of the process of adjustment, necessitated by the conjunction of the two conditions, that x is to change in value relatively to y , whilst x and y are each to retain their same relative position in the domestic price structure of the countries producing them.

The latter condition, which is the effect of the two assumptions introduced earlier in this section, may now be examined more closely. For a certain period, it must be admitted, the earnings in the export industries may be out of line with the earnings of the like factors in the domestic industries. But experience has shown that such a state of affairs is very difficult to maintain, and it certainly does not correspond with a normal state of equilibrium when the factors of production possess any

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degree of mobility between employments. The assumption made in this respect is therefore legitimate for our purpose. Less satisfactory is the other assumption of "constant costs" in terms of the factors of production. In practice a change in the scale of production is likely to be accompanied by a change in the real cost of production per unit, although the direction of the latter change is uncertain. On the one hand the economies of large-scale production make for lower unit costs at a larger output, higher unit costs at a smaller output; on the other hand an enlarged scale of production tends to enhance the relative scarcity, and hence the relative value of those factors of production which are required in a special degree in making the particular commodity, whilst a contraction in the scale of production relieves that scarcity. The extent of the former influence depends on technical circumstances which cannot easily be compressed into a generalization; the extent of the latter upon the degree to which production for export makes special demands on certain productive factors. It will be shown in a later chapter that the selection of certain products rather than others for export is largely dependent on the fact that the production of the former requires the use of a particular factor in an especially high proportion. It is there-

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fore likely that a change in the demand for the exports will have a special effect on the value of that particular factor, and thus affect, *ceteris paribus*, the relative cost of producing the exports.

In so far as there is a change in the relative costs of the export commodities (in relation, *i.e.*, to the cost of domestic commodities) the relation between the general level of costs and incomes in A and B should not change in the same proportion as the commodity terms of trade—the value of x in terms of y —but in a proportion which may be either greater or less.

In our case, in which the original disturbance of equilibrium comes from a falling off of the demand of one country for the products of the other, we may expect production of the export goods to contract in both countries, although it must be remarked that this will not necessarily be so. But, assuming that this does happen, there are four possibilities with regard to the costs per unit in terms of the factors of production of the producing country: (1) they may remain the same in each country, (2) they may change in the same direction, (3) they may fall in A and rise in B, and (4) they may rise in A and fall in B. In case (1) producers' incomes (*i.e.* costs) and domestic prices in A should change in relation to producers'

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incomes and domestic prices in L in the same proportion as the change in the commodity terms of trade. In case (2) the same should happen except in so far as the change in the costs of the exports is greater in one country than in the other. In case (3) the change in the relation between incomes and prices in one country and in the other should be greater than the change in the commodity terms of trade, while in case (4) it should be less.

It will be seen that the change in demand will usually call for some change in the relation between the price and income structures of A and B.

2. The disturbance of the original position of equilibrium may come from a change on the side, not of demand, but of supply.

Let us suppose that as a result of technical changes it becomes much cheaper in terms of B's factors of production to produce a unit of y . The export of y from B will almost certainly expand, and y will become cheaper in relation to x . How far the commodity terms of trade will change will depend upon the elasticities of the demands of the two countries for each other's products. If the demands are inelastic, it is possible, as J. S. Mill pointed out, that the change in the commodity terms of trade will be more than proportional to the cheapening of production in terms of B's pro-

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ductive factors ; and in that case the range of producers' incomes (also of domestic prices) in B should decline relatively to prices and incomes in A. On the other hand, the opposite results will follow if the demands are elastic, so that the decline in the value of y relative to x is less than proportional to the cheapening of the production of y . Or an intermediate position is possible in which the changes in the commodity terms of trade and in the efficiency of B's factors in producing y just balance, leaving the appropriate relation of price and income structures between A and B unchanged.

The general conclusion which appears to emerge from this section and the preceding one is that the range of incomes and prices prevailing in a country depends upon the efficiency of its productive factors in producing for the international market, efficiency being measured not in physical units, but in the international value of the product. More than a hundred years ago this idea was developed by Senior, who maintained that the level of prices and incomes in gold standard countries depended upon the cost of obtaining gold, and that the real cost of gold to the countries which had to obtain it from abroad depended upon the effectiveness of their export industries.

There can be no doubt that this view is substantially correct and provides an indispens-

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able clue to international price relations. It is subject, however, to certain qualifications which may well be explained at this stage.

In the first place, the level of domestic prices must be directly affected by the conditions of domestic production. If a country which is highly efficient (in value terms) in producing for export is also highly efficient (in physical terms) in producing for its home market, while its incomes should be relatively high, there is no reason why the same should be true of its domestic price level. Referring again to Senior's proposition, the level of gold prices within a country depends on the relative cost (in terms of the factors of production) of obtaining gold and of obtaining other commodities, not simply on the cost of obtaining gold. In the foregoing we have been able to ignore the domestic conditions of production only because, in order to isolate the effects of changes in the demand and supply relative to the international commodities, we have assumed other conditions to remain unchanged.

In the second place, the conditions of domestic production in a country have an indirect influence on the level of money incomes earned in production. A country well able to provide its own requirements for itself will only carry on foreign trade on terms favourable to itself; whereas a country ill equipped in this respect

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will be glad to trade on relatively unfavourable terms rather than to curtail its use of foreign products. Hence the conditions under which the home industries can produce for the home market are likely to affect the terms of trade in international exchange, and the latter, as we have seen, have a direct influence on the level of money incomes.

Thus in considering neither the domestic price level nor the level of producers' incomes (money costs) is it desirable to give exclusive attention to the effectiveness of the factors of production for purposes of export. On the other hand, when we are concerned with changes in the international trade situation, it is of considerable advantage to place the emphasis on the relative effectiveness of the resources of the several countries in producing international values, rather than on the relative values of particular commodities. For by looking at the former we are able to bring changes in the conditions of both demand and supply [(1) and (2) above] under one heading, and in addition we find ourselves in a position to take account of the varying composition of the goods entering into foreign trade. In the example given above, we assumed for the sake of simplicity that there were only two commodities which were or could be traded between the two countries. In fact, of course, the

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actual and potential exports of a country commonly cover a range of products, and, if the foreign demand for one of these declines, the adjustment will be effected in part by increasing the exports of other goods and in part perhaps by exporting goods not previously exported at all. To bring about the adjustment—to extend or create the markets for these other goods—changes in the relation of price and income structures as between the countries concerned should still be necessary; but the magnitude of such change will be less than it would be if the first country depended solely on the one export. It follows that when we say that the magnitude of the effect of any disturbance in the conditions of international trade depends on the elasticities of the demands of the various countries for one another's products, we must be understood to refer to the elasticities of the real demands for each country's products *in general*. This wide and somewhat vague conception covers the demand for a number of different products and their elasticities, and it also includes a reference to the adaptability of the resources of the different countries to new purposes.

3. *Import duties and export bounties.* The effect of the imposition of an import duty is to lower the demand for the foreign goods subject to the duty. The importer of these goods in

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the country imposing the tariff has to pay a duty to his government in addition to what he pays to the foreign exporter; for any quantity therefore he will only offer the foreigner a lower price than he would have been prepared to give in the absence of the import duty. Adjustment to the lower demand on the one side will call for the same changes in the terms of trade and in the relation of price and income structures as in the simple case of a decline in demand examined in Section 1.

The extent of the changes evoked by the imposition of a general import duty will depend upon the elasticities of the demands of the countries concerned for each other's products. Were a country which exported goods in urgent (inelastic) demand and imported mainly luxury articles or articles which could be produced at very little extra expense at home, to impose import duties, it is possible that the terms of trade might be turned so much in her favour that her traders might obtain their imports nearly as cheaply as before, even after paying the import duties. On the other hand, in the reverse conditions the gain in the terms of trade would be negligible. In the case of an import duty imposed on particular commodities only, the capacity of the other countries to substitute untaxed goods for the taxed

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exports would also be a factor influencing the nature and magnitude of the adjustment.

The relative rise in the level of domestic prices and incomes which corresponds with the movement of the terms of trade in favour of the country imposing the duty should be distinguished from the difference in the price of the goods subject to the duty, within and without the customs area. The higher price of these goods behind the tax barrier may best be regarded as a tax paid by the citizens to their government—therefore, a transference of income internally. (In so far as the goods subject to the import tax are produced at home and now fetch a higher price, the home producers of these goods will make bigger profits and will bid higher prices for the productive factors which they employ. But this will merely mean a transference of income between individuals, in addition to the transference from individuals to the government. We may still say that the higher price of the dutiable goods does not of itself contribute to a higher range of money incomes.) It is true that we often speak of the foreigner being made to pay the import duty to the extent that the terms of trade move against him; and this way of expressing the matter is quite reasonable, whether the money price of the foreign goods falls as a result of the duty or incomes

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and the price of exports rise in the home country to make foreign goods relatively cheaper. But for our present purpose it is more correct to regard the duty as being paid by the citizens of the country imposing it, and then to think of the movement in the terms of trade as giving them a partial offset against this charge.

So far as the terms of trade are concerned, the effect of a bounty on exports is just the opposite of the effect of a duty on imports. The effect is to raise the country's demand for foreign products in terms of its own, and hence to turn the terms of trade against it. How far the terms of trade are moved depends again upon the elasticities of the international demands. It is theoretically possible, if the demand of the rest of the world for the products on which the bounty is given is extremely inelastic, for the whole benefit of the bounty to go to the foreigner; the country giving the bounty would then export more in order to buy the same quantity of imports as before. But when the foreign demand is ordinarily elastic there will be some increase in imports as well, and although the bounty-giving country as a whole (including the taxpayers) may be expected to lose, some advantage will accrue to its citizens as consumers of imports.

This brings us to the further point that the

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effect of export bounties on the relations of price and income structures is not the opposite of that of import duties. In the extreme case of an inelastic foreign demand, this relation might remain unchanged, but in the more usual cases there should be a relative rise, and not, as symmetry might suggest, a relative fall, of domestic prices and incomes in the country giving the bounty. To explain this point it is necessary to draw a distinction between the terms of trade from the point of view of the country as a whole, reckoning in the bounty on exports provided by the taxpayer, and the terms of trade from the point of view of those concerned with the trade, before the payment of the bounty. In the preceding paragraph we were speaking of the terms of trade in the former sense; but for the relation of price and income structures it is the terms of trade in the latter sense that are relevant, and these must move in favour of the traders of the bounty-giving country, if these traders are to have any share of the benefit conferred by the bounty. They require a favourable turn in the terms of trade (from their standpoint) in order to get a share of the gain in this case, whereas in the case of the import duties (which are payable by them) they require such a turn in order to pass on a share of the loss.

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It may be pointed out, with a view to problems to be discussed later, that the combination of a general duty on imports with an equivalent general bounty on exports would call for a purely monetary adjustment, and, assuming the existence of equilibrium to begin with, would leave both the terms of trade and the volume of exports and imports unchanged. This may be shown most easily in the case of independent paper currencies. Traders exporting to the country adopting the arrangement would receive less in terms of the currency of this country for their goods, as a result of the imposition of the import duties; but this smaller amount of currency would, with the addition of the bounties, purchase as much for purposes of export from that country as a larger amount of currency did previously. Thus trade would be unaffected, and the only difference made by the arrangement would be that a smaller quantity of the currency of the country adopting it would be worth as much as the larger quantity previously in terms of other currencies, *i.e.* the exchange value of this currency would rise. In the case of gold standard countries, the trade and balances of payments of the countries concerned would for a time be disturbed. At first there would be a contraction of imports and an expansion of exports on the side of the duty-cum-bounty

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country, resulting in a tendency for gold to flow in its direction. But an adjustment of relative price levels should remove the stimulus to export and encourage a revival of imports; and since the arrangement is not biased in favour either of encouraging exports or of hindering imports, the eventual state of equilibrium should be the same as the original one. Again only the relation of prices should have changed.

(Those who have followed the above argument will see that the effect of export duties will be the same as that of import duties, so far as the terms of trade are concerned, but the opposite so far as price and income relations are concerned. Foreign purchasers will usually bear some share, however small, of the duties: hence the gain in the terms of trade for the country as a whole. But they are unlikely to bear the whole of the duties, and therefore there must be a relative cheapening of the price at which the exports leave the producers' hands.)

4. *Changes in transport costs.* As Professor Cassel has pointed out, a change in transport costs by which the cost of moving goods in one direction is increased relatively to the cost of moving them in the opposite direction will have the same effect, so far as the relations of prices and incomes are concerned, as the imposi-

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tion of additional import duties by the country towards which carriage has become comparatively expensive. To be quite correct one should look, I think, not merely at the comparative cost of moving goods in general in the two directions, but at the comparative cost of transporting the goods which actually move in each direction. Thus incomes might be relatively depressed in one country as a result of a relative increase in the cost of transporting the kind of goods which it exports. It would appear to follow further that if a change in demand turns the terms of trade against a country, so that it has to give more of its exports for a given quantity of imports, this effect will be aggravated—quite apart from any change in freight rates—by the greater cost of shipping its exports in proportion to their value.

In the case of changes in transport costs, however, what one country gains is not necessarily another country's loss, nor vice versa. Thus a reduction in the costs of delivering A's goods in B will benefit not only A, but B also. For although A's incomes will rise relatively to B's, A's goods will actually be cheaper to purchasers in B in terms of their own products. In this respect the position is similar to that which would result from a technical improvement in the production of A's exports

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when B's demand for these exports is elastic.¹ In both cases B gains absolutely, although it may be said to lose relatively to A. It is only where A and B are competitors for the same foreign market that an improvement in transport from one may really prejudice the other.

5. *Changes in the volume of one-sided transfers of wealth.* Apart from changes in the demand and supply of international products, in the deliberate interferences of Governments with the course of international trade, and in relative transport costs, the existing international equilibrium may be upset by changes in what we have called the one-sided international payments. It may be that the people of a particular country begin to invest abroad on a larger scale than previously; or that they curtail their foreign investments with the result that the interest payments due on previous foreign investments are no longer offset in whole or part by the new investments being made; or that new payments of the

¹ In the case of the improvement in transport, this result will occur whether or not B's demand for A's products is elastic. The difference between the two cases is this: if B's demand is inelastic technical improvements in the production of A's exports will reduce the foreign demand for the employment of A's resources; but in no case can the improvement in transport have this effect—except in so far as A's resources are employed in transport itself.

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character of reparations or war indemnities become due.

These cases present a new feature in that they involve a change in the incomes spendable by the people of the countries concerned, independent of any change in the value of the factors of production (*i.e.* of the incomes earned in production). For example, if the people of A decide to lend an additional x million to the people of B, the former have x million less to spend (including capital expenditure at home) and the latter x millions more. This change in spendable incomes should automatically assist the process of transferring the wealth lent. Having more to spend altogether, the people in B are likely to extend their foreign purchases and also to increase their consumption of their own products at the expense of the amount available for export; whilst the opposite changes are likely to take place in A, where people have now less to spend. So far as this goes, changes are effected in the "visible" trade of the countries which tend to compensate the new one-sided payments, and additional real income becomes at once available in B in the form of additional supplies of both imports and home products. It is possible that this immediate result will suffice to effect the transfer. It is even possible, as has been pointed out by Dr. Haberler

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and Professor Viner, that the change in international demands will be more than is required to effect the transfer automatically, so that A's products will come to be more in demand than B's and accordingly increase in relative value. Assuming that the value to be transferred is represented by 100, we should have the former case if B at once increased its imports from A by 50, and consumed products of its own previously exported to A to the value of 50, whilst A diminished its imports from B by 50 and released products for export from home consumption to the value of 50. We should have the latter case in its extreme form if B sought to spend the whole 100 of additional income on A's products and A to meet the curtailment of its income entirely by economizing in its consumption of B's products.

The latter case seems unlikely to occur in practice. The former may more easily happen and cannot be dismissed as improbable without reference to all the particular circumstances—the character and purpose of the payment, the economic character of the countries concerned, the existence or absence of tariff barriers, etc. But, on the other hand, its occurrence can by no means be taken for granted. It may well happen that the increase in B's imports and decrease in A's imports

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which result immediately from the changes in the income at the disposal of their respective inhabitants do not add up to the amount to be transferred. Moreover, it must be noticed that even the fulfilment of this condition may not alone suffice in a world in which our countries A and B are only two out of many. Consider the following case as an example. A transfer of 100 having to be made, suppose, as before, that A's imports diminish by 50 and B's increase by 50 ; but suppose that A's imports from B only diminish by 25 and B's imports from A only increase by 25. These changes in the direct trade between A and B only provide then for a transfer of 50. A further 25 may be provided for by a diversion to B of exports which a third country C (the rest of the world, if you like) previously sent to A. We have now completely accounted for the changes in the imports of both A and B, and we still have provision for a transfer of no more than 75. For the balance we must turn to changes in the exports of our countries *vis-à-vis* the rest of the world. Now B's capacity to export is indeed reduced by a further 25, since the consumption of home products has increased by 50, of which only half has so far been accounted for by diminished exports to A ; and at the same time resources are set free for export production in

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A as a result of the reduced consumption of home products there (50 less 25 represented by the additional exports to B already counted). But it cannot be assumed that the resources liberated in A will at once and without any value adjustment be able to produce exports as acceptable to the rest of the world as those hitherto obtained from B.

Hence it may be understood that in order to bring about the adaptation of imports and exports required to effect the transfer, it is often necessary that there should be a monetary adjustment such as will render B's products relatively dear and A's products relatively cheap. (Incidentally, it may be remarked that other countries may also be affected, according as their trading interests are competitive or complementary with those of A or B.) As in the preceding cases the adjustment may take the form either of a change in exchange rates (independent currencies) or of movements in the national price and income structures (gold standard currencies). In the latter case, it may be noted, incomes are affected in the countries concerned in two ways. In the first place, there is the increase in incomes in one country and diminution in the other, equivalent to the amount to be transferred and apart from any change in the incomes earned in production. In the second

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place, there is such change in the level of incomes earned in production, corresponding to changes in the terms of trade, as is necessary to enable the transfer to be made.

Again as in the preceding cases the extent of the monetary adjustment, if any, required will depend upon the elasticity of international demands, giving this term the wide meaning explained above. It should be understood, of course, that the monetary change need only be a lasting one if the change in the one-sided transfers—such as an increased flow of foreign investments—is also lasting.

(A difficulty has been deliberately evaded here in stating the amount to be transferred as 100, without specifying the units in which the sum is expressed. Such sums being expressed normally in money, so long as the relations between the national money units and their relative purchasing powers remain constant, a more precise definition of the sum is unnecessary. But if monetary adjustments are required to facilitate the transfer, these would affect, according to some measurements, the value of the sum transferred. This is most easily seen in the case of independent currencies: a payment fixed in terms of one of the currencies will be given a different value in terms of the other currency by a movement of the exchange rates between the currencies.

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In such a case it may make considerable difference whether the payment is defined in one currency or the other; and in either case the value of the payment considered as purchasing power on the world market will be further affected by the degree to which the general exchange value of one currency has risen and that of the other fallen. In the case of gold standard currencies the debt will always have the same gold value in whichever currency it is denominated, but an adjustment in international price relations will alter the real value of gold, if not in general, at any rate as against the goods in which the countries party to the payment are particularly interested. It is obvious that the burden of the payment will be the more serious the more the gold value of the goods exported by the paying country falls.)

To sum up this rather lengthy discussion, we may accept the purchasing power parity theory in its comparative form as a first approximation to the truth. That is to say, we may begin with a general expectation that the prices and incomes in the different countries, reduced to a common basis by means of the actual exchange rates, will move in harmony. But at the same time we must realize that this will only actually be the case if there are no changes in the conditions which

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govern the relations between the national price and income structures, or if any changes in these happen just to offset one another. These conditions relate to the demand and supply of the products of the different countries, their policies with respect to tariffs and bounties, the relative costs of transporting their exports, and the magnitude of the one-sided payments between them. In so far as we are aware of changes in these respects, we should expect the movements of price structures to be divergent.

Between countries of broadly similar economic interests, particularly if those interests are in each case fairly diverse, it is not very likely that changes in demand and supply will necessitate marked divergencies of price movements. This no doubt partly explains why divergent movements were not very conspicuous as between the leading gold standard countries in the years before the War, although differences in the actual price levels were evident enough. So far as these countries were concerned, a more likely cause of changes in price relations would be found in one-sided transfers of wealth, particularly in variations in the flow of foreign investments. In the case, however, of the leading country exporting capital, Great Britain, the necessary transfers were facilitated, firstly by the fact that in the

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earlier phase she was the leading industrial country, so that the borrowing countries would naturally tend to spend a loan on her products; and secondly by the fact that in the later phase the new loans were generally more than covered by the income from previous foreign investments. Moreover, it may be said that both Britain and France (the other country of outstanding importance in the world supply of capital) showed a certain continuity in the scale of their foreign investments, when allowance is made for the effects of the trade cycle. The ease with which France paid the War indemnity of 1871 has often been remarked with surprise, but admits in fact of a fairly simple explanation. The French were already large holders of foreign securities, and in broad terms the payment was effected by the exchange of these foreign securities for new issues of French *rentes*, and the sales of the former abroad. It is not pretended that these few references take us far in the direction of establishing agreement between theory and fact; and it must be recorded that Professor Taussig, himself the leading modern exponent of the theory that international equilibrium is maintained through price adjustments, is inclined to think that much of the evidence suggests a more instantaneous adjustment of trade to changes in one-sided payments than

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this theory would lead one to expect. (The weight which one would naturally assign to Professor Taussig's very candid doubts is mitigated by two considerations. In the first place, these doubts are in large part directed towards the part played by gold movements in bringing about changes in price relations rather than towards the part played by those price changes—however initiated—themselves. Though important, this does not seem to be the major issue. In the second place, where price movements do come into consideration, Professor Taussig appears often to have looked only at what was happening in one country, instead of at the relation between prices in that country and prices elsewhere.) But the evidence with regard to Britain, France, Germany, and U.S.A., has yet to be disentangled in such a way as to allow us to test our theory in detail over any considerable period. Meanwhile it may at least be said that the broader facts with regard to the position of these countries are not in evident conflict with the theory.

The most striking verification which the theory has yet received has been provided by Professor Viner's study of the Canadian balance of payments in the period 1900-13. In this case it seems to be fairly well established that an unusually large volume of foreign borrow-

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ings was accompanied domestic prices and incomes. newer countries, apart from the U.S., the best opportunities for illustrating the importance of the factors affecting international price equilibrium. Their export products are in the main distinct from those of the leading gold standard nations and much more limited in range; in many cases they are almost entirely dependent on the export of one or two products. In so far as their leading products are agricultural, they are also very much affected by the vicissitudes of the seasons. In consequence their international equilibrium is peculiarly liable to be upset by changes in demand and supply. Again in the world capital market these countries are borrowers, and as the international flow of capital has always been from a few lenders to a comparatively large number of borrowers, the inflow of loans to the several borrowers has exhibited much less continuity than the outflow from the lenders. Thus, an import surplus due to a preponderance of new borrowings has often had to be changed rapidly to an export surplus, required by a preponderance of the interest charges on previous borrowings. Finally, there has been a natural tendency for the flow of loans to cease when trade conditions in the borrowing country are bad, so that an

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to be created at pre-difficult time. The instability of payments resulting from conditions has been particularly apparent in the case of the South American countries, and is unmistakably connected with the difficulty which they have experienced in remaining for long on the gold standard and with the fluctuations in the exchange value of their currencies during the intervals of inconvertibility. It is true that difficulties arising on this side have not uncommonly been aggravated by internal inflation. But this further factor has not always been present and has not often been the factor initiating the disturbances. The view that nothing is to be learnt from the history of South American currencies save the dangers of political mismanagement is a very common one, but is mainly the result of certain preconceived notions inherited from the controversy over the depreciation of the English currency during the Napoleonic Wars. Ricardo then maintained that the depreciation of the currency was solely due to the over-issue of Bank of England notes, which had been made inconvertible in 1797. It is not clear that in the end he meant any more than that the depreciation might have been avoided by a sufficient restriction of the note issue ; but in the course

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of the discussion he denied that such things as the payments of subventions to our allies abroad, or the necessity of importing grain on an unusual scale in certain years, had any tendency to cause exchange depreciation. It was perhaps unfortunate that his view was not more heeded at the time, when a closer control of credit might have been useful. It has been no less unfortunate that in subsequent years it came to be thought that he had said all that was to be said on the subject of depreciating currencies.

CHAPTER IV

DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

IN the preceding chapter we have developed, along more or less traditional lines, a theory of international price equilibrium. Finding that a stable balance in international dealings depends upon the existence of appropriate relations between the national price and income structures, we have inquired into the circumstances which determine those appropriate relations. At any time the actual price relations may differ from those appropriate to the existing conditions. But then the position will be unstable, and movements of the exchange rates, or movements of the price levels in response to gold movements, should tend to bring about the appropriate price relations.

The idea that there exists a natural tendency to equilibrium in international trade is the central principle of the whole theory of our subject. Just for that reason, however, its truth must not be taken for granted too readily; and in the present chapter we shall

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consider whether there are not some cases in which the tendency fails to operate effectively.

Experience shows that a failure of a country's balance of payments to find a position of stable equilibrium is most likely to occur when that country has an inconvertible paper currency. In such cases there is often considerable uncertainty with regard to the future exchange value of the currency. Although there are, as has been shown, rates of exchange which are normal or appropriate to the given circumstances, towards which the actual rates should tend to gravitate, these rates cannot be known at the time with anything like the precision with which the metallic parities between gold standard currencies are known; and they are constantly liable to be changed, moreover, by movements of internal prices and changes in the other underlying factors. As a consequence of this uncertainty, casual and seasonal influences on the exchange rates are less likely to be offset by dealings undertaken in anticipation of a reaction, whilst persistent influences tending to depress the exchange value of the currency are likely to give rise to a "bearish" sentiment, or expectation of further decline, which may greatly exaggerate their force.

According to the theory advanced above, however, a decline in the exchange value of

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the currency is the appropriate corrective for an adverse balance of payments in this type of case ; and from this it might well appear that even an excessive decline would not be of serious consequence, since it would merely have the effect of inducing a temporarily favourable balance.

At this point it is necessary to notice that the theory that equilibrium is to be restored by a relative cheapening of the products of the country with an unfavourable balance is based on the assumption that the demands for foreign products are characterized by elasticity rather than by inelasticity—in technical terms, that on the whole their elasticity is greater than unity. In general, and *with reference to gradual changes in price* or value per unit, this assumption appears to be in accordance with the facts. One can think of a country, such as Brazil, which is faced with an inelastic demand for its exports ; and one can conceive of a country, a manufacturing country perhaps, importing mainly necessary foodstuffs and raw materials, which has an inelastic demand for its imports. But in these cases one would expect there to be a sufficient degree of elasticity in the demand respectively for the country's imports or exports for adjustment to take place on that side. It is doubtful if there is any country which normally

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experiences rigidity in the demand for both its exports and its imports. But the case is different if we are thinking of the response of demand, not to small and gradual changes in price, but to the abrupt changes which may result from rapid movements of exchange rates. In such cases we shall certainly expect the quantities demanded to change and to change considerably. But there is no assurance that the immediate change in quantities will be great enough to outweigh the change in values per unit; and unless this happens the relative cheapening of the one country's products will have failed to improve its balance of payments, and may actually have the opposite effect. This unfavourable contingency seems most likely to occur in the case of a country which depends on the elasticity of its exports for the adjustment of its international balance. However attractive the terms on which it offers its goods to foreign purchasers new trade connexions take time to establish; and in some markets special import duties may offset the effect of the depreciated exchange. Moreover, even if the demand for the country's exports can be readily extended, the supply may prove insufficiently elastic. Theoretically, in this last case the price of the exports in terms of the currency of the exporting country should rise, and this should help

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to maintain, if not increase, the total value of the exports. But here again inertia may delay the proper reaction.

In this analysis, as throughout the preceding chapter, in speaking of the effect of a change in the exchange value of a currency on the balance of payments, we have been referring to the effect on new transactions currently being arranged, it being assumed that goods are priced in the first instance in the currency of the country producing them. Variations in exchange rates may also affect the balance of payments by changing the value of payments due under contracts previously made. In practice it is unlikely that the debit and credit items in the balance of payments will all be defined in terms of the same currency, or will be defined in different currencies in the same proportions, and it therefore follows that a movement of exchange rates is likely to alter the relation between the two sides of the account. This consideration is of importance both because of the existence of long-term contracts and because, if we are taking a short view, the majority of payments due at any time are governed by contracts previously made. But it is impossible to make any general statement about the direction of this effect on the balance, given an upward or downward movement in the exchange value of

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the currency. If we imagine the case of a country having all its debits denominated in its own currency and all its credits denominated in the currencies of other countries, it is clear that any deficit in its balance of payments, however large, could be wiped out by the depreciation of its currency, provided that the depreciation went far enough. But if we take the reverse case it is equally clear that depreciation would only make the balance of payments worse. And the one case is no more typical than the other.

Neither through its influence on the values of current trading nor through its effect on the values of existing debts, therefore, will exchange depreciation necessarily bring any immediate improvement in the balance of payments. How, then, is even a temporary balance between debits and credits obtained? Sales of securities to foreigners at prices made attractive by the exchange depreciation may contribute something towards meeting the deficit, but it will probably be necessary to supplement these by selling foreigners notes or balances in the home country itself. At some point foreign speculators will feel that depreciation has gone too far and will purchase the depreciated currency in anticipation of its subsequent recovery. But the equilibrium attained in this way will be in the highest

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degree precarious, since the point at which sufficient foreign support will be obtained will shift with every change in speculative opinion.

So far we have taken rather a short view of the effects of exchange depreciation. In the course of time the normal elasticity of demands and adaptability of productive resources should make themselves felt, and one would then expect there to be a recovery of the exchange value of the currency to a higher and more stable position. Experience does in fact show that this may happen. But on the other hand there is another possibility at least as well illustrated in currency history, and that is that, before recovery has time to take place, the exchange depreciation may drag down the internal value of the currency.

In admitting this possibility we are abandoning another of the assumptions on which the previous analysis has been based, the assumption namely, that in the case of paper currencies the internal price - and - income structure (apart from the price of imported goods) is independent of the international position. In the case of gold standard currencies price structures have been supposed to be flexible, but in that case it has been argued that an adverse balance of payments will have deflationary consequences. What we have now to contemplate is an adverse balance

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of payments leading through exchange depreciation to a general *rise* in prices and incomes, which will undo the corrective effect which should be exercised by the exchange depreciation when demands become elastic.

This, from the purchasing power parity standpoint, reversed relationship between exchange rates and the general price level may establish itself in several ways. In the first place, as has been recognized throughout our analysis, exchange depreciation will normally raise the price of imports. Now if the demand for these imports is inelastic, their total value in terms of the home currency will also increase, and increased credits will be sought at the banks by those who trade in them or work them up into more finished products. Should the increased credits be obtained, the extended purchasing power will pass from the borrowers into general circulation and so tend to raise other prices as well. Again, if the price of imported goods plays an important part in determining the general cost of living, the higher import prices will lead to demands for higher wages which, if conceded, would in turn lead to higher working costs and larger credit requirements. (Alternatively, if the Government attempts to keep down the cost of living by subsidizing essential foodstuffs, this may result in inflationary credit oper-

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ations on the Government's account.) On the other side, the export industries are almost certain to increase their output, even if the foreign demand is inelastic, whilst the home currency price of their products is likely to rise somewhat; so that on this side also it will seem reasonable to expect extended credits from the banks. These various demands for additional loans may indeed be resisted, if the control of credit is sufficiently strict; or the expansions of credit allowed in some directions may be offset by contraction in others. It is not being argued here that exchange depreciation must inevitably lead to a general expansion of credit attended by a general rise of prices. All that is contended is that depreciation may in practice have these consequences and has in fact often had them.

Another link in this exchange depreciation—inflation sequence may be provided by the existence of a large government floating debt, which requires to be renewed at short intervals. With the fall in the exchange value of the currency, holders of Treasury bills and similar securities may become unwilling to renew them, either because they see a more profitable use for their funds in financing trade, in response to the demands referred to above, or because they are rendered so apprehensive with regard to the future value of the currency that

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gilt-edged securities which only promise a fixed return in terms of that currency appear too unsafe. In either case the Government will be in difficulties to repay the loans and will probably have to borrow the money from the central bank—that is, to resort to inflation. This illustrates the kind of vicious circle which may be set up, loss of confidence and exchange depreciation leading to inflation, and inflation leading to further loss of confidence and further depreciation.

In extreme cases of depreciation another type of situation develops. In effect the national currency ceases to be used as independent unit of account; prices are adjusted from day to day and even from hour to hour in accordance with the movements of the exchange rates, and long-term contracts are expressed either in foreign currency values, in gold, or in some other commodity. In these circumstances the exchange value of the currency completely dominates the internal value and may itself be anything speculation decides.

The difficulties which we have been describing, and which might be illustrated by many examples from the post-War history of European currencies, are such as may result from a too low valuation of a currency in the exchange rates. It may also happen that the anticipations of the market give a paper cur-

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rency a higher exchange value than can be permanently maintained. In this case the consequences are less serious and the trouble can be more easily remedied. There is no danger of a collapse of the currency system, and a local tendency to deflation can be more easily overcome than the opposite movement. But while it lasts the over-valuation of the currency can be extremely inconvenient, particularly for the industries exposed to foreign competition.

Between countries on the gold standard the monetary adjustments necessary to maintain equilibrium take, as we have seen, the form of movements in the national price and income structures. Experience would suggest that in this case there is no danger, analagous to the main danger in the case of paper currencies, that the movement of price structures will be excessive. The possibility that the mechanism may fail to function correctly results rather from a tendency of price structures to be too rigid. From time to time conditions will call for important changes in the relation between the price and income levels of certain countries or groups of countries, but on both sides the proper adjustment may be resisted. On the one hand a country in which incomes and prices should become relatively lower may shrink from deflation

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with its immediate prospect of depression and unemployment; on the other hand a country in which incomes and prices are due to rise relatively may be inclined to hinder the expansion of credit for fear unhealthy boom conditions may develop. For a while, therefore, and perhaps for a considerable period, equilibrium will be maintained in a makeshift fashion with the aid of short-term loans from the country or countries which tend to have a credit balance. The confidence engendered by adherence to the gold standard makes it comparatively easy for a country to obtain such loans by offering the lenders a very slight advantage in interest rates. But this process cannot continue indefinitely, and any shock to confidence may bring a sudden demand for the repayment of the short-term debts. Something of a crisis will then be inevitable and the debtor countries may even find it impossible to remain on the gold standard. If this is abandoned, the exchange rates will become more or less free and equilibrium may eventually be established by monetary adjustment in this form. But the dislocation will be more violent than would have been necessary if the exchange rates had been allowed to adjust themselves to the situation continuously.

The possibility just outlined has an obvious relation to the course of events which led to

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the abandonment of the gold standard by Great Britain and a number of other countries in the autumn of 1931. On certain points the interpretation of these events gives rise to differences of opinion. According to one very prevalent view, the breakdown of the gold standard is to be attributed to the policy of the "creditor" countries. These are accused of having "sterilized" gold, in other words of having prevented incoming gold from exercising its full influence in the direction of raising prices. On the other hand a case can be made out against the debtor countries on the ground that they shirked deflation in face of a persistently weak position in their balance of payments. Both these views find the cause of the difficulties in the failure to work the gold standard properly, and their upholders might agree that the essential difference between the pre-War and post-War gold standard system has been the greater regard shown of late for the stabilization of conditions within each country. But according to a third view the real source of the difficulties has been the exceptional strain imposed on the international monetary system in the post-War years. Reparations and other War debts are cited in the first instance, and it is shown that the difficulties inevitably associated with these payments have been greatly aggravated

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by the tariff policy of the creditor countries and by their reluctance to make large-scale foreign investments of a permanent kind. That they have at times been very willing to make short-term foreign investments has in some ways been an additional source of embarrassment. To have met these conditions by the orthodox gold standard mechanism would have required, it is suggested, price adjustments so drastic as to be beyond the range of practicable monetary policy at any time.

In this theoretical outline it is hardly necessary to decide between these interpretations of the events. But the events themselves warn us against the assumption that the adherence of the leading countries to the gold standard necessarily ensures smooth and speedy adjustment to all possible changes in the underlying conditions.

CHAPTER V

THE THEORY OF COMPARATIVE COSTS AND THE INTERNATIONAL DIVISION OF LABOUR

UP to this point we have been almost exclusively concerned with the monetary adjustments necessary to maintain international equilibrium. Changes in demand and supply have been referred to as factors calling for new monetary adjustments ; but the existence of an international interchange of commodities has been taken for granted, and we have yet to consider the *real* conditions of demand and supply which make that exchange possible. In other words, we have still to inquire into the part played by international trade in the utilization of the world's resources.

In part the answer is very simple. The different countries comprise different parts of the earth's surface, in many cases widely divergent in climate and other natural conditions. As a result of these natural differences, products which are easily obtained in some countries are almost impossible to produce in others ; and in so far as the people of one

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country desire goods which it is only practicable to produce in other countries, the satisfaction of their demands must depend upon international trade. International trade is, therefore, a means of adding to the range of commodities available in each country. It was doubtless on this basis that international exchange originated and much of the present-day international trade can also be accounted for in this way. In the modern world, however, we commonly find that countries import goods which it would certainly be possible for them to produce for themselves; and in the absence of duties restricting imports such cases would be commoner still. In fact the extent to which protection is practised or proposed gives a fairly good measure of the tendency of international trade to develop beyond the first rudimentary stage. This tendency is one towards a higher degree of international specialization, and our next task is to discover the principle upon which this specialization is based. (We may here pass over the complication that at the present day countries are often found both to import and export the same commodity on a considerable scale. The explanation of this is usually either that the goods imported and exported, although recorded under the same name, are in some respects different, or that the trade is between different

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parts of the country and other countries more accessible to the respective parts than these parts are to one another.)

This is the problem which Ricardo and his successors sought to solve with the theory of comparative costs.

To understand their solution it is first necessary to recall their general theory with regard to the exchange value of commodities and the distribution of productive resources. This was based on two assumptions, firstly that labour was mobile or readily transferable between places and employments within any country, and secondly that labour was the only element in the cost of production of goods. With respect to the latter assumption Ricardo did indeed recognize that the use of capital involved a cost in the form of interest, but he endeavoured to evade this complication by supposing that capital was always employed in association with labour in a constant proportion. In this way, and by a similar assumption that the different grades of labour were always combined in constant proportions, he sought to reduce the real costs of production to homogeneous units of labour. Given these assumptions, and given competition between both labourers and entrepreneurs, it followed that wages would be equalized between all places and employments, and that the prices of com-

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modities would be in proportion to the of production in labour. And since c tion would only allow of the existenc price for each commodity, it would also . that goods would be produced in those pla where their cost of production in terms of labour was cheapest.

This theory was applicable to each country separately, but it could not be applied to the world as a whole and used as an explanation of the international division of labour, because between countries the assumption of mobility of labour could no longer be sustained. In the absence of international mobility, there could be no tendency towards an international equalization of wages. International trade, like domestic trade, must be governed by prices, but the prices of goods produced in different countries need not be proportionate to their *absolute* labour costs.

This brings us to the heart of Ricardc's special theory of international trade—the theory of comparative costs. Having, on the assumption that labour is completely immobile between countries, a fixed supply of labour, each country will concentrate that labour force in the production of those goods in the production of which it has the greatest advantage (or least disadvantage), and will import from other countries those goods in the production

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h it has the least advantage (or the disadvantage). International trade on differences in the *relative* costs of making the various commodities in different countries, commodities moving from countries in which, on the basis of home costs, they would be comparatively low in the scale of values to countries in which on the same basis they would be comparatively high in the scale of values.

The theory is usefully illustrated by a few imaginary examples. For the sake of simplicity, it is customary at least to begin with cases in which there are only two countries and only two products ; let us say countries A and B and products x and y . We are supposing that both products can be produced in either country, and let us say first that in A 10 days' labour will produce 20 units of x or 10 units of y whilst in B 10 days' labour will produce 15 units of x or 10 of y . Then, in accordance with the theory, A and B will tend to concentrate respectively on the production of x and y , and to exchange those products. A has an advantage in the production of x , and although B has no absolute advantage in the production of y , it has a comparative advantage inasmuch as it is not at the same disadvantage in producing y as it is in producing x . Assuming that labour costs per unit are not affected by

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changes in the scale on which the commodities are produced in each country and neglecting transport costs, the total advantage resulting from specialization and exchange can be shown thus: 20 days' labour devoted to producing x in A together with 20 days' labour devoted to producing y in B yield in total 40 units of x and 20 units of y , whilst the same amount of labour divided equally in each country between the production of x and y yield only 35 units of x and 20 of y . From the point of view of country A, it will be advantageous to export x in exchange for y provided it has to give less than 2 units of x for 1 of y ; from the point of view of country B it will be advantageous to export y in exchange for x , so long as it can obtain more than $1\frac{1}{2} x$ for 1 y .

Now let us vary the case by supposing that 10 days' labour in A will produce 40 units of x or 20 units of y , whilst the returns to labour remain as before in B—15 x or 10 y for the 10 days. It is to be noticed that in each country the relative costs of producing x and y are the same as in the previous example, the change in the efficiency of labour in A affecting the absolute costs of producing x and y equally. Accordingly, trade should develop on the same basis as in the preceding case. Notwithstanding the fact that the *absolute cost* of producing y in terms of labour is twice as

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great in B as in A, B will still be able to offer y to A in exchange for x on terms which will make it more advantageous for A to obtain its supply of y in this way than to produce y for itself: *i.e.* on terms of exchange less than 2 : 1. For this trade to be possible, it will be necessary for the money wage of a day's labour to be lower in B than in A. But on the conditions supposed this will necessarily be the case. If we suppose money wages to be initially the same in both countries, this will mean that both x and y are at first cheaper in A, and (neglecting transport costs still) that both x and y —the only two commodities entering into foreign trade—will be imported from A into B. This unbalanced trade will then lead, as we have seen, to monetary adjustments as a result of which wages in B will be reduced relatively to those in A. When this process of adjustment has been carried far enough, y will become cheaper in B than in A, whilst x will still remain cheaper in A.

As our last variation, let us suppose that the conditions of production in A are the same as in the first case—10 days' labour yielding 20 x or 10 y , and that in B 10 days' labour produces 15 x or $7\frac{1}{2}$ y . In this case no permanent trade is possible, because, although there are differences in the absolute costs of production as between A and B, there are no differences

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in comparative costs of producing x and y in the two countries. In both countries x must be half the value of y , and no adjustment of wage levels can make it pay to import one and export the other.

On one point the Ricardian theory was incomplete, even as an account of such simple cases as those we have been considering. In the two cases above in which trade is possible between A and B, it has been shown that any terms of exchange between $2x$ for $1y$ and $1\frac{1}{2}x$ for $1y$ will give some advantage to both countries. What will the actual terms of exchange be? How is their position within the range determined? The importance of this question was recognized early, for the location of the terms appeared to govern the division of the total gain from the trade. But the earlier exponents of the theory could suggest no better answer than that it depended upon the "higgling of the market"—in other words on bluff.

The problem would become more determinate in some cases if we abandoned the assumption of "constant costs," and allowed for a change in the amount of labour required to produce a unit of either commodity with the change in the scale on which that commodity is produced in each country. It is true that if unit costs fall as the scale of production

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increases, and vice versa, the further the international specialization is carried the wider will become the range of terms on which trade is possible. For each country will specialize in producing the commodity in which it has a comparative advantage, and the enlarged scale on which this is produced will increase the comparative advantage. But if unit costs vary in the opposite direction, the range will be narrowed, and if the demands are large enough, it may be narrowed down to a point.

For the completion of the theory, however, it was necessary to consider the relations between the demands of A for y and B for x . It was J. S. Mill who first pointed out that, although both countries would wish to trade on any terms within the range set by comparative costs, it by no means followed that all of these terms would result in a *balanced trade*. For a balanced trade, the terms must be such that the amount of y which A will wish to purchase with x (on those terms) will cost exactly the amount of x which B will wish to buy with y . Since the amount of y which A will wish to buy and the amount of x which B will wish to buy, will both tend to vary with the terms of exchange, this condition will not be fulfilled by any range of terms, if the demand on either side is at all elastic. The exact position of the terms which give equilibrium

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will depend partly upon the comparative scale of A's original demand for y and B's original demand for x , and partly upon the comparative elasticities of demand. Thus if in our first case A's demand for y is comparatively large, A will be led to offer very nearly 2 x for 1 y , in order to induce B to enlarge its purchases of x . Or again the same result might ensue when the demands are on the same scale (in the sense that the original quantities of y and x demanded by A and B respectively would balance on some such terms as $17\frac{1}{2} x$ for 10 y), if the cheapening of y to A purchasers (from 20 x for 10 y) would greatly extend their demand for y , whilst the cheapening of x to B purchasers (from 10 y for 15 x) would make little difference to their demand for x .

There can be no doubt that Mill's addition was essential to the completion of the theory. But it must be observed that in adding to the theory he altered certain of its presuppositions and thereby invalidated certain of its conclusions, apparently without realizing that he was doing so. In the original formulations of the theory it appears to have been assumed that the amount of labour devoted in each country to obtaining x and y together, whether both were produced at home or one was obtained by exchange, was fixed. It was then possible to calculate definitely the total gain

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from international specialization, and to represent the division of that gain between the two countries as dependent on the position of the terms of trade. Thus in our first example there was a gain of 5 x , and if the terms of trade were 17 x for 10 y , A would gain 3 x (giving 17 x instead of 20 x for 10 y) and B 2 x (obtaining 17 x instead of 15 x for 10 y). But once we have recognized that the quantities demanded vary with the terms of exchange, this method of calculating the gain ceases to be applicable. If A's demand for y in terms of effort is elastic, it will not only purchase more y when foreign trade reduces the price from 20 x for 10 y to 17 x for 10 y ; it will devote more labour to obtaining y through exchange for x than it would have devoted to producing y for itself. The gain from foreign trade should, therefore, be calculated in another way, by comparing the imports with the most valuable goods which might be produced for home use, whether the same in kind as the imports or not, by the labour devoted to the paying for the imports with exports.

The inadequacy of the Ricardian theory, so long as it ignored the quantitative aspects of demand, becomes still more apparent when we have to deal with cases in which there are more than two countries and more than two tradeable commodities. For example, let us

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suppose that we still have our two countries, A and B, but that there are three commodities, x , y and z . Let us say that A has the greatest advantage in producing x and least in producing z ; in other words, that so far as x and y are concerned, A has a comparative advantage in producing x , but so far as y and z are concerned, A has a comparative advantage in producing y . What form will the trade then take? Will A export x and import z , each country providing itself with y ? Or will A export x and y and import z ? Or export x and import y and z ? Or suppose that there are only two commodities, x and y , but three countries, A, B and C; and that C has a comparative advantage in the production of y as compared with A, and in the production of x as compared with B. Will C export y to A in exchange for x and x to B in exchange for y ? This is in general unlikely. C in all probability will trade with A only (y for x), or with B only (x for y), or it will trade with neither. But which of these three possibilities will in fact be realized? The most precise knowledge of the labour costs of producing the several commodities in the several countries will not by itself enable us to answer any of these questions. To obtain answers it is necessary to take account of the scale and elasticities of the demands for the various commodities, and also

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to allow for the one-sided payments which have to be made between the countries—which so far have been ignored in this chapter. These considerations determine not merely precisely where the lines are drawn between the goods a country exports, those which it produces for itself, and those which it imports, but whether that country is an importer or an exporter of particular goods.

Neglect of the demand factors was one general failing of the earlier theories of value. Another was the idea that on the supply side costs were to be measured solely in terms of labour and wages. Later theories have all recognized the existence of other elements, particularly interest, in costs of production, and have seen that the proportions in which, for example, capital and labour are combined, are not constant for all commodities. None the less the classical formulation of the comparative cost theory has been generally retained even to the present day, the method of exposition being to begin with the assumption that the only costs are homogeneous labour costs, and then to point out the modifications necessitated by the fact that the relative values of capital and labour, and of the different grades of labour, vary from country to country.

This procedure is somewhat cumbersome and leaves us in the end without any clear state-

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ment of the principle governing international specialization. It seems better to follow the example of the Swedish economist, Professor Ohlin, and base our theory at the outset on modern conceptions of value.

On one cardinal point the Ricardian theory remains entirely unimpaired; the international exchange of goods must depend on differences in their comparative values in the countries concerned. If, in the absence of international trade, the relations between the prices of the various goods were the same in all countries, no permanent system of exchange could be established; and where it exists, international trade must leave sufficient difference in the price relations to cover the cost of international transport. The question at issue is how these differences in comparative values are to be interpreted in terms of productive conditions.

According to the theory of value most generally adopted at present, the values of commodities, while depending in the first instance on demand, are normally regulated by the values of the factors of production by which they are made; and the values of the factors depend upon their scarcity. By the scarcity of the factors, however, is meant not the smallness or largeness of their supply, considered absolutely, but their shortage in rela-

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sion to the demands for their use. To have any value, to be taken into account at all, the factors, available in convenient location, must fall short of the quantity which could usefully be employed. Given that this is the case, the value put upon their use will be such as to reserve them for the most important uses—the uses, that is, in which they yield the highest returns. The value thus determined by the competition of alternative uses is a cost from the point of view of the entrepreneur, and, by limiting the use of the factor in all employments, it keeps up the value of the products. (It is to be understood that it is not as a rule a question of reserving the use of a factor for one kind of product to the entire exclusion of another kind of product, but of determining how much of the factor should be available for one product and how much for the other. The larger the supply of each product the lower its value will be and the lower the returns it affords to the factor; the factor will be distributed between them so as to get the maximum returns per unit.) The relative values of the products depend upon the degree to which their respective supplies are restricted in this way, in other words, upon the comparative scarcity of the factors required for their production.

This is the theory for an isolated community.

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If as between two countries, in the absence of trade, the relative values of commodities differ, this means that there is a difference in the comparative scarcity of the different factors of production. Now on the opening of trade each country will specialize in the production of those goods which are relatively cheap in that country ; it will therefore extend those branches of production which use a high proportion of those factors which it possesses in relative abundance, and contract the branches which use a high proportion of the relatively scarce factors. A country which has large areas of fertile land and a scanty population will specialize in grazing or the more extensive forms of agriculture and import manufactures and other products which call for relatively large quantities of labour ; a country with a dense population of little education and low standards will specialize in "cheap labour" crops, such as tea, sugar or flax, according to climate and soil, or in the coarser forms of manufacture ; another country with a dense population, but that of more wealth and education, will specialize in the more elaborate or capitalistic forms of manufacture ; and so on.

The effect of international trade will be in the direction of equalizing the relative scarcity of the factors and rendering their relative

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values more uniform. In each country the most scarce factors will tend to become less scarce and the least scarce more scarce. In fact, as Professor Ohlin has shown, international trade in commodities may be regarded as a substitute for the international mobility of the factors of production. Ideally one would be able to move the factors around and assemble them just where they were wanted in just the right proportions. In so far as this is impossible (and of course most of the natural factors are quite immovable), the next best thing is to adapt production in each country to the distribution of the factors, and then to exchange the products.

To characterize the international specialization which develops so far as transportation costs and other obstacles allow, it suffices to say that goods are produced where the necessary factors are least scarce, omitting the "comparative" qualification (as if we should say "least scarce in comparison with the factors required for another commodity," on the analogy of the theory of comparative labour costs), and omitting any further reference to international demands. For once trade is opened, the scarcity of the different factors in each country depends upon the conditions of demand and supply abroad as well as at home, and their scarcity value serves to

discriminate between competing uses for both foreign and home markets. To illustrate the principle, let us again consider the case of two countries, A and B, and three commodities, x , y and z , arranged in the order of A's initial comparative advantage. To simplify the exposition we will also suppose now that these three commodities are the only commodities produced at all, not merely the only tradeable goods produced. It may first be pointed out that, in the absence of international trade, there would appear to be no possibility of differences in the *general* scarcity of the productive factors as between the two countries; for scarcity depends upon demand, and in each closed community ownership of the factors located there would be the only source of demand. It follows that the *extreme* differences in comparative scarcity are what may here be termed differences in absolute scarcity (although scarcity is always relative to demand); that is to say that the x factors are less scarce in A and the z factors less scarce in B. About the y factors no such statement can be made, but if the eventual result is that A imports y as well as z , the explanation must be that the demand for x (internal and external) is such that the factors common to the production of x and y have a scarcity value in A which makes the whole group of factors

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required for producing y more scarce in A than in B. Similarly if there are a number of countries—the case which has to be considered in practice—the form assumed by the specialization of each depends on the scarcity of the factors, as influenced by international as well as national demands. It may be added that there is nothing in this theory to require that a country which imports a particular commodity should not produce any of that commodity for itself. Factor values regulate *how much*, as well as *what*, shall be produced in a particular country.

To some extent this same principle can be said to cover the movements of goods which give effect to one-sided payments between countries. For the fact that the payment is being made would tend of itself to make the productive factors less scarce in the paying country and more scarce in the receiving country in the absence of an adjustment in the movement of commodities. But, as we have seen earlier, the requisite trade adjustment may not be achieved without an additional monetary adjustment, and this will mean a change in factor values which is not the result of the disposition of demands, but which is needed to divert demands in the right direction for equilibrium.

It has been more or less implied in the pre-

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ceding argument that for each commodity there is a distinctive combination of the factors of production, constant for all countries. On this basis the advantage of international trade is that it makes it possible to constitute these combinations where the components are least scarce. But in fact a certain amount of variation is usually possible in the combination of factors required to produce a particular commodity. Wheat, for example, may be produced by extensive cultivation, using relatively much land and little labour to produce each quarter, or by intensive cultivation using proportionately more labour and less land; manufactures may be produced by more or by less capitalistic methods. These variations usually occur in practice, as between one country and another, because differences in the relative scarcity of the factors make different combinations more economical in each case; and they will be the more marked the more countries have to be self-dependent. This brings us to a second way in which international trade helps to economize the factors of production; namely, by enabling goods to be produced by the combination of the factors which has the lowest scarcity value for the world as a whole.

From the point of view of each country, the gain from international trade may be said to

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result from diverting resources from satisfying less important requirements (measured by money demand) to satisfying more important requirements. In so far as the goods imported were previously produced at home, resources are set free which produce goods in greater demand than those sacrificed by diverting other resources to producing exports; in so far as the imports exceed the quantity which would otherwise be produced at home, or are goods of a type which would not be produced at home, they will themselves be more in demand than the goods sacrificed to produce the exports.

To some who have approached the problems of international trade under the influence of the older point of view, it has appeared that the specialization which is the basis of such trade might in some cases lead to a worsening of a country's productive conditions. Professor Frank D. Graham, in particular, has contended that if the specialization which develops between two countries is such that country A specializes in producing a "diminishing cost" commodity, whilst country B concentrates on an "increasing cost" commodity, then the result will be disadvantageous to B. The terms "diminishing" and "increasing cost" refer to the variation of unit costs as the scale of production increases, it being assumed that the variation will in each case be in the oppo-

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site direction when the scale of production contracts. In country B then the unit costs of producing both commodities will rise as a result of the expansion of the increasing cost industry and the contraction of the diminishing cost industry. Since in country A the unit costs for both commodities will fall, the relationship between the home costs of production of the two commodities in each country, and therefore the terms on which trade can be conducted, will not be materially affected. Hence B is likely to suffer from the increasing costs of producing the goods which it exports without obtaining compensation in a relative cheapening of the goods which it imports. On this basis Professor Graham has argued that a restriction of trade by Protection might be in the interests of the raw material producing countries.¹

To judge the validity of this argument it is necessary to consider rather carefully what is meant by the tendencies to diminishing and increasing costs. The former depends simply on the technical economies which can be effected with a larger scale of production, the scale of production meaning in this connexion the volume of production within a particular country. Economies of this kind are to be

¹ For the full argument, see "Some aspects of Protection Further Considered." *Quarterly Journal of Economics*, Vol. XXXVII, No. 2.

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obtained in the production of almost all commodities as a result of the possibility of spreading certain more or less fixed costs over a larger output. If it is understood that we are referring to the size of the national output and not to the size of the various undertakings by which this output is produced, and that production here includes distribution and marketing, it should be clear that there is no distinction with respect to this tendency between agricultural and manufacturing production. So far as this tendency goes, therefore, international specialization should bring advantages all round.

If nevertheless an increased volume of production leads in fact to increased costs per unit, it must be because this first tendency is overborne by another in the opposite direction. Our understanding of this second tendency depends on conception of costs. Professor Graham would appear to follow the earlier economists in thinking of real costs as measured in some physical units. Such an attitude was intelligible enough so long as labour was regarded as the sole element in costs of production. Moreover on this basis it was not unreasonable to regard the tendency to diminishing returns or increasing costs as being especially characteristic of certain branches of production, such as agriculture or mining,

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which depend on the co-operation of rather closely limited natural resources. But once it has been recognized that the conception of costs must cover the use of a number of distinct factors, combined in varying proportions, the matter must be regarded altogether differently. It is impossible to sum the various components of costs except on the basis of their value, and that depends, as we have seen, on their scarcity. The tendency to increasing cost simply means then that to expand the production of a particular commodity is to encounter increasing scarcity of those factors which this branch of production especially requires. This again is a general tendency, not peculiar to certain classes of commodity.

On this interpretation, the tendency to increasing costs must always be mitigated by the development of international trade since the latter means that in each country there will be a contraction of those branches of production in which the scarcity of the factors of production is greatest. It is true that it will at the same time have the effect of increasing the scarcity of the more abundant factors in each case—the factors, that is, which are chiefly used in the export industries. But the resulting tendency towards the equalization of the relative scarcities of the productive factors

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will affect all countries equally, and will merely set a natural limit to the extension of international trade. Should the product in which one country is specializing offer peculiarly few opportunities for obtaining the economies of large-scale production, that will also be a circumstance restricting this specialization. But none of these considerations suggests that specialization will be other than advantageous to all parties, so far as it is likely to go.

Professor Graham appears to assume that the contraction of the industry in B which enjoys the technical economies of large-scale production will be accompanied step by step with a rise in the price of its product. From the argument above it follows that there will be a counteracting tendency as a result of the diminishing scarcity of the factors it uses. But apart from this, Professor Graham surely postulates too immediate a connexion between cost of production and price. It is well known that the disposition of producers to resist the contraction of their business, even at the cost of making temporary losses, is peculiarly strong in precisely this type of industry. This disposition provides a safeguard against the contraction of their industry beyond the point justified by the comparative scarcity of the factors of production.

CHAPTER VI

PROTECTION AND THE REGULATION OF INTERNATIONAL TRADE

IN explaining the principle on which the international specialization of production is naturally based, we have at the same time demonstrated the general advantages of international trade. If this view of the subject is accepted, it would appear to follow that the international exchange of commodities ought to be as free as possible from all restrictions and hindrances. All inter-regional specialization is necessarily restricted by the cost of transporting goods; to add to this impediment by imposing duties and prohibitions on the movement of goods across political frontiers is not necessary and is, on the face of it, uneconomic.

It appears indeed to be very generally conceded that such artificial restrictions on international trade are inimical to the interests, or at all events the purely economic interests, of the world as a whole. To some this consideration alone is decisive in favour of Free

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Trade. It is not necessarily the case, however, that the policy which is best from the point of view of the whole world is also best from the point of view of each country individually, and it is from a frankly nationalist standpoint that the policy of Protection is usually advocated.

Probably most Protectionists would agree, then, that any gain which one country may derive from its own protective policy is accompanied by injury to others. Now since almost all countries are at present practising Protection to a greater or less degree, it follows that each Protectionist country is suffering from the trade restrictions imposed by the others. On this ground many Protectionists would also agree that it would be a good thing for each country, as well as for the world as a whole, if all these restrictions could be abolished, although they might add that the abolition ought to be effected gradually, in order to avoid too violent a dislocation of the industries which have grown up in dependence on protective tariffs. But the prospects for achieving a general "tariff disarmament" of this kind are by no means bright, and meanwhile the Protectionist maintains that each country is right in pursuing its protective policy with a view to advancing its own interests. The fact, indeed, that other countries

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are practising Protection appears to some to provide a reason for their particular country to impose import duties which would not be justifiable, even from its own point of view, if imports were admitted free by the others. With some idea of redressing the balance, Protection is opposed to Free Trade as "Fair Trade."

Although Free Traders are apt to be more international in their outlook than Protectionists, it would be altogether mistaken to think that Free Trade is only to be advocated from a cosmopolitan point of view. Looking at the matter solely with regard to the interests of his own country, the Free Trader maintains that Protection can only lead to the diversion of productive resources from one employment to another, and that, in accordance with the theory of international trade, this will mean using those resources less effectively than they would be used under Free Trade.

In support of his contention that Protection means merely a change in the use of productive factors and not the employment of additional factors, the Free Trader relies on two lines of argument. In the first place he postulates that the balance of payments of any country as against the rest of the world is normally in stable equilibrium; although

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temporarily this equilibrium may be upset, it will tend to re-establish itself automatically. Now if this is true, it necessarily follows that any artificial restriction of imports by duties must be accompanied by a corresponding change in the other items in the account, in order that the balance may be maintained. The compensating change might take the form of an increase in any of the other debit items or a decrease in any of the credit items; for example, foreign borrowings might be diminished or foreign investments increased. But unless they are deliberately contrived, there is no reason to expect these adjustments to take place in the international capital movements: there appears to be nothing in the change in the volume of imports to cause them.¹ Hence it is concluded that the adjustment will normally take the form of a contraction of exports (as compared with the volume of exports which would have taken place if the imports had not been restricted), and the increase in the factors employed in producing substitutes for the imports will be balanced by a decrease in the factors employed in producing for export.

¹ The improvement in the balance of payments might indeed lead to a reduction in the Bank rate and hence to an outflow of funds to other money markets. But this may be regarded as a merely transitional effect.

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It may at first seem rather arbitrary to assume that the adjustment must be made in the volume of exports, just because there is no reason to expect it to take place in the other items. In truth, however, the assumption is not an arbitrary one, although the nature of the connexion between a restriction of imports and a contraction of exports is often imperfectly understood by Free Traders themselves. In popular expositions of the Free Trade case it is generally argued that import duties must injure the export industries, partly by increasing the cost of their raw materials, and partly by increasing the cost of living and therefore the level of wages. The point with regard to the cost of raw materials contains a considerable amount of truth. It would be very difficult to devise a system of protective import duties which did not fall, directly or indirectly, on goods used as the raw materials of some export industry, and it may well be doubted whether such a system would satisfy the Protectionists of any country. But the extent of the damage inflicted on the export industries in this way must vary with the details of every tariff system. It is possible to exempt the raw materials and semi-finished products used by at any rate the leading export industries from the duties, or to give "drawbacks" (*i.e.*

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return the duty) in respect of exported goods made with imported materials subject to duties. So long, therefore, as the Protectionist is attacked on this ground, it is possible for him to argue that the handicap imposed on exporters need not be of more than secondary importance. The other argument, respecting the cost of living and its effect on wages, would appear to imply that wages are governed by a perfectly rigid standard of living—an idea which has been discarded with the “subsistence” theory of wages. A much better understanding of the connexion between imports and exports is shown by those who argue that, if we curtail our imports, the foreigners will not be able to afford to buy so much from us. As, however, modern foreign trade is not conducted as barter between national units, but by individual transactions in terms of money, this reasoning may be found rather too simple. In accordance with what has been said in an earlier chapter, the complete and correct argument is that import duties tend to raise the level of incomes and costs in the protected country in relation to the level of incomes and costs in other countries, and hence to make all its products comparatively dearer to the extent required for the restoration of international equilibrium. In this way, it should be noted, the export

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industries will find their competitive advantage reduced, even if they use absolutely no materials directly affected by the duties. It is because these price adjustments must affect trade, but do not ordinarily affect one-sided transfers of wealth, that we are justified in expecting the balance of payments to be restored by a contraction of exports.

As a second line of argument, leading to the conclusion that Protection can only cause a diversion of resources from one channel to another, the Free Trader may contend that we have to assume that the factors of production are normally fully employed in every country. This assumption requires some explanation. In the first place, for the productive factors as a whole to be fully employed, it is not necessary that every type of factor should be used to the utmost. For example, international competition may render it unprofitable to exploit certain mineral resources which were previously worked in a particular country. This is not to be taken to mean that there is a general diminution in the employment of the country's resources, because the mines could only be worked with the employment of other factors, and these are presumed to find better employment now in other directions. In the second place, it has to be recognized that a certain amount of unem-

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ployment in the productive factors is in itself normal. Thus in all countries which afford reliable statistics of labour unemployment, we find that there is never a time when the whole available labour force is in employment, and that there are recurrent periods when a considerable portion of that force is unemployed. But this wastage, common to both Protectionist and Free Trade countries, appears to be necessitated by the discontinuities in our productive system as at present managed, and does not indicate therefore the existence of a margin of resources available for new industries.

If the Free Trader is granted his assumption with respect to the utilization of the factors already available in the particular country, the Protectionist may still argue that tariffs will lead to the employment of more factors there as a result of the introduction of capital or labour from abroad. This argument may be supported by references to numerous cases in which firms which have found their export markets barred to them by tariffs, have established factories with their own capital behind the tariff barrier. But in order to show that tariffs are likely to lead to a net inflow of capital or labour, it is necessary to show that they will make the protected country as a whole a more attractive field for the employ-

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ment of these resources, as compared with other countries. Is this in general probable? If the restriction of trade is a disadvantage to all parties, will not the restrictions adopted by a particular country injure that country itself to a greater extent than any other single country? At all events there is no general presumption to the contrary.

These considerations in favour of Free Trade from the point of view of each particular country do not depend at any point, it must be emphasized, on the adoption of a like policy by the other countries. It will be better for our particular country if the other countries pursue a liberal policy in admitting imports; but if they take the opposite course, our country will make matters worse for itself as well as for the others by following their example. Tariff barriers may be likened to physical impediments to the interchange of commodities; and on this analogy for one country to impose import duties because other countries do so, appears as little reasonable as for one country deliberately to obstruct its own harbours because those of other countries are bad. When the effects of foreign tariffs in dislocating particular industries are being considered, moreover, it has to be remembered that the industries which are particularly prejudiced by the foreign duties, namely the export indus-

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tries, are precisely those which will suffer from the further restriction of trade by duties imposed by their own country.

There is one respect, however, in which the tariffs of one country may offset or neutralize the effects of the tariffs of other countries, namely so far as the terms of trade are concerned. We have seen earlier that import duties tend to turn the terms of trade in favour of the country imposing them, that is, to enable that country to obtain its imports more cheaply in terms of its exports; and it might seem that in this connexion retaliation would be reasonable and expedient. As a rule, however, the extent to which a country can turn the terms of trade in its favour is very slight; for under conditions of competition a very small relative rise in the price of the products of a particular country will substantially curtail their market. In exceptional cases, in which the country imposing the duty has more or less a monopoly of a product in inelastic demand, whilst its own demand for foreign products is elastic, the effect might indeed be considerable; but in such cases the other countries are clearly in a very weak position for retaliation. Moreover it is important to remember that the advantage which a country derives from its foreign commerce depends upon the extent of that

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commerce as well as upon the terms upon which it is conducted. If two countries are retaliating against one another with import duties, a position may be reached in which the terms of trade are the same as would prevail in the absence of the duties ; but the amount of trade carried on will be appreciably less, and in ordinary circumstances it would almost certainly pay either country to abolish its duties and carry on a larger trade on somewhat less advantageous terms.

Retaliatory tariffs are more often advocated as a means of bargaining. So far as this is strictly the object in view, the tariff is not intended to be in operation for any length of time, if it ever comes into effect at all, and its efficacy depends on the advantage of its withdrawal to other countries rather than on the advantage of its maintenance to the country imposing it. Tariff policy of this sort, therefore, involves quite different considerations from those we are discussing here, and maybe be more conveniently considered in a subsequent chapter. It may be remarked in this place, however, that "bargaining tariffs" would seem much less attractive if the disadvantages which a country incurs in restricting its own trade were more clearly recognized.

If the theory of international trade worked out in the preceding chapters is correct, then,

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Free Trade is to be recommended as a general policy both for the whole world and for each country, and (saving any possible gains through using the tariffs as a bargaining weapon) for each country irrespective of the policy of the other countries. There are, however, circumstances in which there is more to be said for protective tariffs or some other form of State regulation of international trade. Accordingly we have now to consider certain special protectionist arguments. We shall only deal with arguments which accept our general theory of international trade; thus we shall ignore the plea of particular industries for duties to equalize costs as between them and their foreign competitors, since differences in costs are the basis of all international trade. And we shall first consider arguments which accept the usual free trade assumptions, that the balance of payments will regulate itself and that the productive factors will in any case be utilized to the normal degree. Afterwards, however, we shall discuss certain cases to which these assumptions do not appear appropriate.

1. Perhaps the strongest of the special arguments for Protection is that known as the Infant Industries argument. This is based on the difficulty of establishing an industry in a new region in competition with the producers

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in other regions where the industry is already fully developed, even although the new region may compare quite favourably with the older ones in point of the resources required for the industry. The case for Protection on this ground was recognized by J. S. Mill in a famous passage : " The only case in which, on mere principles of political economy, protecting duties can be defensible is when they are imposed temporarily (especially in a young and rising nation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on the one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A country which has this skill and experience yet to acquire may in other respects be better adapted to the production than those which were earlier in the field : and besides, it is a just remark of Mr. Rae, that nothing has a greater tendency to promote improvements in any branch of production than its trial under a new set of conditions. But it cannot be expected that individuals should at their own risk, or rather to their certain loss, introduce a new manufacture, and bear the burthen of carrying it

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on until the producers have been educated up to the level of those with whom the processes are traditional. A protecting duty, continued for a reasonable time, will sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment.”¹

In order to justify a claim to protection on this ground, the producers in the country in which the industry is new must be able to show that there is a good prospect of the removal of their disadvantages as the industry grows. This implies that resources as good as those in use in the industry elsewhere can sooner or later be obtained without their withdrawal from more advantageous employments.² To make out a strong case it should be shown, moreover, that the disadvantages on which the claim for help is based are *external* to the individual concerns in the industry, part of their environment rather than of their own organization. For the business men engaged in developing the industry in the new region ought presumably to be prepared to face the kind of risk which attends the establishment of a new concern in a region

¹ *Principles*, Popular Edition, p. 556.

² In such cases, however, it may be legitimate to anticipate the introduction of certain factors from abroad

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where the industry is already carried on—especially as distance will give them a certain degree of natural protection in their local market. In the passage quoted, Mill refers particularly to the cost of training the labour supply of all kinds (“the producers” in his words). Here the deterrent is not merely the cost which the pioneer firms will have to incur, which will mean a temporary loss if they have to sell in competition with the mature industries of other regions, but also the possibility that later comers in their own region will compete with them for the labour supply once it is trained, and thus deprive them of any opportunity of recouping their losses. This type of difficulty also arises in other directions, *e.g.* in the necessity of nursing ancillary industries. A somewhat different, although not unrelated, difficulty occurs when an industrial development calls for the simultaneous co-operation of entrepreneurs in what are customarily distinct classes of business. Each class may hesitate to advance through uncertainty as to the intentions of the other classes, and in such circumstances a tariff or some other form of governmental encouragement may be helpful in giving a lead.

The case particularly contemplated when the Infant Industry argument was first put forward was the fostering of manufacturing

industries in countries which had hitherto been almost entirely agricultural. It may be held that the same principle applies to the establishment of new industries in countries which are already industrialized, if those industries happen to have been developed earlier in other countries. Thus extended, however, the argument must be received with more reserve. The differences in the technique employed and the kind of environment required are usually less marked between one modern manufacturing industry and another, than between agriculture and manufacturing in general. Hence the impediments to the spontaneous development of new industries are less serious in the advanced industrial countries, and the fact that such a country has so far neglected a particular industry affords a special ground for the suspicion that that industry is one for which the country is not really suited.

The policy of protecting growing industries aims primarily at benefiting the protecting country, but, if it is successful in achieving its purpose, it will contribute at the same time to the general prosperity of the world. At first the application of the protective duties will inevitably cause dislocation and result in a general over-development of the particular industry. But—always assuming the necessary conditions are fulfilled—the final result should

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be to promote a better allocation of the world's resources, if only through the avoidance of unnecessary transportation. This consideration distinguishes this particular argument for Protection from most if not all others.

In theory it must be admitted that there may be cases of the sort envisaged by this argument, in which Protection will have beneficial results. The difficulty in applying the policy is to pick out these cases, the danger that industries will be encouraged to develop which will never be able to be self-supporting.

During the nineteenth century many countries sought to foster their young industries by protecting them from the competition of the products of other, more industrialized countries, particularly Britain. Accordingly, it might appear that there should be ample evidence by which to judge the success of the policy and to determine its proper limits. In fact, however, the evidence is very difficult to interpret. The first question is whether the young industries have so developed under protection as to be able to hold their own in the world, and the easiest way to settle this question would appear to be to inquire whether they have subsequently been prepared to dispense with Protection. On this test the policy would have to be declared an almost complete failure, for it is extremely difficult to find cases

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in which producers who have once enjoyed protection have been willing that it should be withdrawn, or in which it has in fact been withdrawn. This, however, is not really conclusive. The protection of their own industry costs producers nothing, and however strong their competitive position may be at the moment, there is always the possibility that it may be weakened by some future developments; therefore they will always cling to Protection as long as they can. The fact that Protection is retained does not show that it is necessary for the maintenance of the protected industries, or that it makes any difference. A more decisive test is to determine whether the goods in question can now be produced as cheaply in the protected country as elsewhere. But this point is not always easily decided. If the duties have been high enough to cut off foreign competitors, the tastes of the home consumers may have developed along distinctive lines; the particular kind of goods which they have become accustomed to buy may be cheaper in their country than elsewhere, but this may be merely because the producers in other countries have not had occasion to produce just those goods on any scale. Moreover, comparisons of the prices of similar goods in different countries may fail to take account of the extent to which

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demands are still being canalized by Protection. Thus suppose that Australia imposes import duties on woollen cloths with a view to developing her own woollen manufactures, and not only taxes the ordinary quality cloth which she may be able to make fairly well for herself, but taxes with especial severity the finest cloths which nobody supposes she will be able to produce, at any rate for many years to come. (Whether or not this is a correct description of this part of the Australian tariff does not matter for our argument.) In these circumstances it may happen that only a small minority of Australians can afford to buy any but ordinary standard cloths, and that for the markets thus secured for these the Australian manufacturers will soon be able to produce as cheaply as Yorkshire. But this result will not be evidence of the successful application of the Infant Industry argument, in so far as the removal of the tariff would lead to a dispersion of demand and the reduction of Australian production to a scale unprofitable at competitive prices. It might still be held, of course, that such a result would justify continued Protection—that the sacrifice of the luxury taste in cloth is of not much social importance; but that would be to go beyond the scope of the argument we are at present considering.

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Despite these difficulties of comparison, it can hardly be doubted that there are numerous cases in which protected industries have developed so as to render the continuance of Protection superfluous, even from the point of view of keeping out competitive products. But this is not enough; these cases can only be cited in support of the argument if it can further be shown that without Protection this development would not have taken place, or would only have come about more slowly. The industrial development of Germany and United States, for example—the two countries which can most plausibly be referred to in illustration of the benefits of Protection—has clearly been based mainly on their natural resources and the aptitudes of their peoples; it can hardly be thought that any trade policy would have kept them chiefly devoted to agriculture and the handicrafts. To those who think that Protection is always necessary if an industry is to be developed in a new region in competition with older centres, Professor Taussig has given a convincing answer by pointing to the establishment of flourishing industries in the southern and middle-western states of the United States, unprotected from the competition of the older industrial regions in the eastern states.

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The most that can be inferred from history in favour of the Infant Industry argument would appear to be that Protection has sometimes accelerated the right developments. On the other hand there is always the risk that developments will be encouraged which will not eventually justify themselves. It is difficult to point to cases in which Infant Industry Protection has been misapplied, because Protection has seldom been adopted expressly on this ground and on this ground alone. But it is clear that in many cases Protection has fostered industries which give no indication of being able to stand without this support. And if a mistake is made, it is almost impossible to rectify it. It is sometimes suggested that Protection should be given for a strictly limited period, and that if the industry in question has not established itself sufficiently well to face competition by the end of this period, it should be allowed to go under. Provisions of this kind have in fact been adopted in tariff legislation. Experience shows, however, that in practice such Protection is almost certain to be renewed. In this connexion, it is worth remarking that Professor Taussig's careful studies of the effects of pre-War Protection in America have convinced him that, to give a new industry a fair chance of establishing itself, Protection may have to be retained for

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as long as thirty years.¹ Clearly Protection for a generation cannot be regarded as a mere experiment. The very factors which necessitate so long a period—human conservatism and inertia—will forbid the abandonment of whatever has been accomplished in the way of building up an industry.

The fair conclusion with regard to this argument appears to be, therefore, that the protection of young industries may sometimes be beneficial, but that it is a measure to be applied with great caution.

Protection is also advocated—at the moment of writing, for example, in England—as a means of assisting *old* industries, which have fallen behind their foreign competitors in efficiency, to reorganize themselves. In so far as it is expected that the protection will achieve its purpose in a limited period, this type of Protection has a resemblance to the protection of new industries. But in other respects the two cases present important differences. In the first place, as has been pointed out, the Infant Industry argument depend, in its most convincing form, on

¹ *Some Aspects of the Tariff Question*, p. 22. It should be noticed that in allowing so long a period, Professor Taussig was taking a more sympathetic view of the Infant Industry argument than he had held previously.

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remediable disadvantages in the individual producers' environment, rather than on deficiencies internal to their own businesses. In the second place, whilst there is a certain presumption that an industry which is struggling to come into existence will, if it is given the chance, adopt the most suitable methods and organization, there is considerable danger that the protection of an industry which has fallen into difficulties largely through its conservatism and lack of initiative will simply result in the perpetuation of the old faults. In both respects, therefore, the argument for a "reconstruction" tariff is weaker. Presumably the special circumstances which are considered to justify the protection are more psychological than material. The strict Free Trader holds that competition will always stimulate progress, whilst security tends to produce stagnation. In opposition to this, it may be contended that there are times of acute discouragement, affecting a particular industry or a number of industries, when the effects are reversed. The economist is hardly entitled to rule out this possibility altogether, but would be reluctant to endorse a policy based on no more concrete grounds. The case would be stronger if the protection could be made effectively conditional on progress being made in reorganization. It is extremely diffi-

cult, however, to contrive this. Protection promised only for a short period would usually be of no use at all; and if its continuance is to be assured so long as the industry in question makes reasonable headway in solving its problems, some outside authority or tribunal must be assigned the almost impossible task of determining whether this condition is fulfilled.

2. The foregoing arguments for protective import duties are based on the principle that it may be wise for a country to impose on itself a certain immediate loss, by restricting its trading opportunities, in order to strengthen its productive powers for the future. In some cases in the past, duties and prohibitions have been imposed on certain *exports* with the purpose of preserving the country's economic advantages—which again implies a certain sacrifice of present for future interests.

There are two types of case in which it may appear reasonable to restrict exports from this point of view: (a) that of exports which are likely to increase the power of the importing country to compete with the industries of the exporting country, *e.g.* exports of machinery first introduced in the manufacturing industries of the exporting country, or of animal breeding stocks of special quality; and (b) that of exports of important raw

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materials which can only be obtained from a limited, exhaustible supply, *e.g.* timber and minerals of various kinds.

However much it may be in the interest of the world in general that the most up-to-date machinery should be available for every country capable of using it, it cannot be demonstrated that a particular country may not gain by keeping an invention to itself. It is practical rather than theoretical considerations, therefore, which have led to the general abandonment of the once common restrictions on the exports of machinery. An important circumstance contributing to this change has been the specialization, as a result of which the work of improving mechanical technique has been largely transferred from the industries using the machines to special machine-making industries. The latter naturally desire the widest possible market, and the machine-using industries have come to realize that they stand to gain most by the proximity of flourishing and progressive industries of this sort. A further factor has been, of course, the increasing ease with which ideas are communicated from country to country; to prohibit the export of machines or even the migration of mechanics, would no longer be a very effective way of safeguarding the secret of inventions. In the case of animals, free-

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dom of trade has been assisted by the fact that England, which has long been one of the foremost countries for raising pedigree stocks, has been more interested in extending the sources of animal food and raw materials than in conferring monopolistic advantages on her own agriculturists.

Restriction of exports in the other type of case—with a view to conserving limited supplies of natural resources—has survived longer and is still practised by some countries to-day. In principle the arguments for restricting exports in these cases are also arguments for regulating home consumption, but in practice the danger of a too rapid exploitation of the resources often only arises when the products can be disposed of in the world markets. In all cases in which a decision has to be made with respect to the wisdom of conserving resources for the future, the great difficulty is to estimate the future conditions of demand and supply in a world in which industrial technique is progressing rapidly. A country which restrains itself from using up its resources quickly may find that later they have little or no value.

Some countries impose duties on the export of raw materials in a crude state with a view to fostering the industries which work up the materials at home. Unless covered by the

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Infant Industry argument, however, this is merely an example of general Protectionism, and not one of the special cases we are now considering.

3. In a number of arguments in favour of Protection the underlying idea is that the regulation of foreign trade will result in greater economic *stability* within the protected area, and that this is worth securing even at some sacrifice in the average prosperity of the community over a period.

It is sometimes thought that a general system of protective import duties will in ordinary circumstances have this result; but it is difficult to find any justification for such a belief. It is true, of course, that if foreign trade is so restricted by Protection that it plays a very subordinate part in a country's economic life, that country will be comparatively little affected by disturbances in the trade of the rest of the world. But such a country will only suffer the more from disturbances peculiar to itself. In order that it should stand aside from international trade, the prices of its exportable products must normally be higher than those at which like products sell in the rest of the world, whilst its prices for importable products must not be so much higher that it pays to import them despite the tariff. In these circumstances it

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will be difficult to relieve temporary over-production in one of the country's industries by selling abroad or to relieve temporary under-production by importing from abroad. In practice, however, advanced countries do not attempt to push Protection to such lengths, and their foreign trade remains sufficiently important to influence their whole economic life. The result of Protection is not, therefore, to give immunity from general world disturbances; and if it in some cases reduces the influence of these, it can only be at the price of increasing the severity of local disturbances. At the same time it must not be overlooked that protective tariffs are themselves the source of serious disturbances. No tariff system has ever been left unchanged for long, and the periodic revisions mean general uncertainty and—in many cases—the disappointment of expectations. If appeal is made to experience, it will not be found that Protectionist countries have been conspicuous for economic stability.

Since the operation of the ordinary tariff systems is to leave some prices exposed to world competition, and other prices (within certain limits) at the mercy of local conditions, other methods of regulating trade have been proposed from time to time with a view to stabilizing the prices of particular pro-

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ducts. One of the oldest of these is the sliding-scale tariff, under which the import duties are progressively reduced as the market price in the protected area rises, so that imports are allowed with comparative freedom during times of scarcity but rigorously excluded in times of plenty. In recent years the establishment of official Import Boards, with the sole right of importing particular products, has been suggested with the same end in view. The idea is that the Boards should make their foreign purchases as far as possible in times of abundance and cheapness, but should hold over excess supplies until times of comparative scarcity. Both of these proposals relate particularly to agricultural products, of which the prices vary considerably from year to year.

The difficulty in the way of the successful working of such schemes is that of knowing even approximately the figure at which the price of the commodity in question should be stabilized. If the problem were the elimination of fluctuations around a more or less constant mean, its solution would present little difficulty. But the real problem is very different. If one studies the price records of a commodity over a number of years, one can distinguish several different types of variation. First of all, in the case of agricultural products, there is the year to year variation,

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determined by the character of the seasons. Secondly, there are the variations in conformity with the general ups and downs of the trade, covering a cycle of about seven years. Both of these may be called short-period variations. But underlying these, there can be discerned more persistent tendencies for the price to rise or fall. These "long-period trends"—which may be peculiar to one commodity or common to a number of commodities—are the outcome of fundamental changes in the conditions of demand and supply and of the behaviour of the monetary system. They may continue for a generation or more; but on the other hand the rate and even the direction of these long-period price tendencies may themselves change at any time; the trend will not be a straight line. Now the aim of the schemes which we are discussing must be to eliminate variations of the first type, or conceivably of the first two types, and to leave the long-period tendencies to operate unchecked. But at the time of its occurrence, it is impossible to know how much of a price change is to be assigned to each type of variation. Consequently there is a great danger that the policy of stabilization will run counter to the long-period tendency. For a time the price will be held, but sooner or later a persistent divergence from the world

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level will compel its abandonment. To stabilize the price for a time, to foster the expectation of its continuance, and then to allow a sudden "break," is likely to cause much more dislocation than the fluctuations of a free market.

In certain circumstances, however, the arguments for intervention in the interests of stability are stronger. To begin with, the uncontrolled development of international trade may sometimes lead to excessive dependence on a single export product. In the case particularly of new countries, development tends to be concentrated on the exploitation of resources of a certain type, leaving the growing demands of the community to be satisfied through the exchange of a very limited range of exports. If the demand for, or supply of, these exports is subject to fluctuations—and particularly if the demand is also inelastic—such a position may, as we have seen, result at times in serious embarrassments. In the general interest some sacrifice of average prosperity may be warranted as a kind of insurance premium; but clearly private initiative will not voluntarily choose the less profitable course. Hence in such cases the argument for the diversification of economic interests supplements the Infant Industry argument as a basis for Protection.

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Protection by means of import duties tends to reduce a country's dependence on its foreign trade, and hence on the market for its exports. But by itself, it can hardly meet the difficulty. A country of the kind we are considering must necessarily continue to import many of its essential requirements. In addition it will probably have considerable interest payments to make to foreign countries. On these accounts the maintenance of its exports at a certain value will still be necessary, if its position is to be satisfactory. It would thus appear that policy should be directed towards diversifying exports at least as much as towards making the country more self-sufficient; and that import duties should be supplemented by bounties and other forms of assistance to new export industries.

The Free Trader may object to all these proposals that if a country pursues the course of development which is most profitable in normal years or on the average, it will accumulate the wealth and acquire the credit to tide it over years of exceptional difficulty. There is force in this argument, and it suggests an alternative line of policy which may be preferable to interference with the allocation of economic resources. It does not really justify, however, an attitude of *laissez-faire*. If the country is to depend on the accumulated

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profits of the 'good years to help it through the bad years, care should be taken that these profits are available in an appropriate form for the time of need

Another important type of case in which intervention is *prima facie* justifiable on the same general grounds is where a country's industries are threatened with disturbance by the "dumping" of foreign competitors in their home market.

The term "dumping" is used in a number of different senses. In popular usage it appears often to be extended to cover any foreign competition which the home producers are unable to meet successfully. To prevent dumping in this sense would obviously be to forgo most of the advantages of international trade. Used more accurately, the term implies the sale of goods for export at a lower price than that at which the home market is supplied. Sometimes the application of the word is further restricted by taking it to mean sales abroad at a price below the cost of production. This again may mean that the export price is below the special costs incurred in producing the exported goods, or merely that it is below the average cost per unit—a distinction which is obviously important when an extension in the scale of production brings a fall in unit costs. Here we may follow the

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more general practice amongst economists in assigning the term the wider meaning of price differentiation in favour of the export market, noticing the relation of the export price to cost of production incidentally. (It is possible, of course, to have export sales at a price below cost of production without having discrimination between the home and foreign markets, *e.g.* in a trade slump. But the problems thus raised from the point of view of the importing country are those which we have already discussed in connexion with the possibility of stabilizing the prices of particular commodities.)

Save in the case in which the government (or some other public authority) is giving some kind of bounty on exports, dumping will only occur when there is some form of monopolistic arrangement amongst the producers of the dumping country to maintain prices in their home market. Moreover, the practice is usually dependent on the protection of the dumpers' home market by import duties. This facilitates the maintenance of the local monopoly, and places an obstacle (additional to transport costs) in the way of the reimportation of the dumped products.

Given these institutional conditions, there are several sets of circumstances in which producers may find it profitable to sell their goods

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for export at a price lower than that at which they are selling for the home market. In the first place, the difference may simply result from the fact that they are unable to charge in competitive markets the extortionate price which their monopoly enables them to exact at home. This is a case of dumping according to our definition, but, as it obviously raises no problems for the importing countries, we shall not be further concerned with it. Secondly, they may be faced with the possibility of reducing their average cost of production per unit by extending the scale of their production. If now the demand for their product in their home market is inelastic, so that an increased supply to that market means a considerable falling off in the price which can be obtained, the most remunerative course may be to keep supply and price in the home market much as before, and to sell the additional output at a lower price for export. This export price may even be lower than the average cost of production per unit, the apparent loss here being balanced by the reduction (owing to the increased scale of production) in the cost of the non-dumped products. Provided that the export or dumping price covers the addition to total costs occasioned by the production of the dumped goods, there is no reason why this form of

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dumping should not be continued indefinitely. Thirdly, producers may dump abroad in order to get a footing in a foreign market, or to ruin financially weaker competitors. Fourthly and finally, they may dump in order to get rid of surplus products without spoiling their home market during periods of trade depression or temporary overproduction. The last two forms of dumping differ from the first two in being from their nature temporary or intermittent ; and in these cases the export price may be below even the direct cost of production.

Protection by import duties is advocated to safeguard home producers from the dumping of foreign competitors in all but the first forms ; and it is sometimes urged that Protection should be adopted to enable the home producers to carry out the second kind of dumping themselves from behind a tariff barrier. So far as this sort of dumping is concerned, however, an examination shows that it is the importing rather than the exporting country which benefits. The producers in the importing country of the goods which are being dumped are naturally affected adversely, as they would be by any increase in foreign competitive power ; but the importing country as a whole benefits as much as it would from any discovery of a cheaper source of supply abroad. In the exporting country, the

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consumers of the goods which are being dumped abroad—including often industries using these goods as raw materials—do not necessarily pay a higher price than they otherwise would, because of the export dumping; they need not be “taxed” to pay for the cheap exports. But they will probably pay a higher price than they would under Free Trade and in the absence of the producers’ monopoly. And clearly they receive a smaller share of the gains from the extensions in the scale of production than the foreign importers.

But dumping of the third and fourth types presents a different problem to the importing country, because of its temporary character. The advantages of exceptionally cheap supplies for a limited period may easily be outweighed by the disadvantages resulting from the derangement of its productive resources. Hence we find here further cases in which Protection may feasibly be resorted to for the purpose of securing economic stability. The stability aimed at is stability of price, but the disturbing influences which it is sought to eliminate are certain specific artificial influences.

In practice, however, the identification of obnoxious dumping is not so easy as it may appear at first sight. Without incurring considerable expense in collecting information as to prices in the producing country, it is almost

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impossible to prove the existence of dumping at all ; and discrimination between the dumping which is likely to be more or less permanent and beneficial and the harmful, sporadic dumping presents still greater difficulties. Moreover, duties which are to counteract dumping fully, and to do nothing else to interfere with the course of international commerce, require constant adjustment to the changing situation. Assuming that satisfactory administrative machinery can be devised for the purpose, the sudden changes in duties are likely to be extremely disconcerting to importers in exercising their natural function of seeking supplies in the cheapest markets. Whether protection against dumping is worth while, despite these difficulties, depends on the extent to which the objectionable forms of dumping are practised and the vulnerability of the home industries.

Where dumping is based on state subsidies, its existence is generally easier to detect. Here again the main question which should be considered in deciding the policy of the importing country is the degree of permanence to be expected in the relatively cheap source of supplies. It may be added that there is no reason to distinguish for this purpose between bounties given on the whole production of a certain commodity and bounties given on the

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amount exported. For while the former will not result in dumping as we have defined it (*i.e.* price differentiation between national markets), it is on the face of it an artificial arrangement and therefore liable to be abandoned.

A problem somewhat similar to that of sporadic dumping is raised by the competitive advantage given to a country in foreign trade by the undervaluation of its currency in the exchange markets. This is in fact commonly called "exchange dumping," although it is not dumping in our sense, since there is no differentiation between the price for export and the price for the home market.

This case arises of course when the so-called dumping country has a depreciated paper currency. It appears often to be thought that such a country has an advantage in exporting which is to be measured by the difference between the current rate of exchange and the parity rate when the currency was on the gold standard; and it is on this basis that other countries which feel themselves adversely affected by the dumping commonly fix their countervailing duties. This, however, is a mistake. When a country is not on the gold standard, it depends on adjustment in the exchange rates for the maintenance of its international equilibrium; and the equi-

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librium rate at any time may be much below the old gold parity. Moreover, the equilibrium position may be one which entails exports on an unusual scale, if mistrust of the depreciating currency gives rise to a "flight of capital." Undervaluation, in the proper sense, measured by reference to the equilibrium rate determined by the conditions prevailing, is of course possible, and will result in an undue expansion of the country's exports. But there is always a tendency for this state of things to be corrected automatically. Either the excessive depreciation should cure itself through its effect on the balance of trade, or it will be followed by a general rise in internal prices and costs. Only in the case of continuous depreciation will the lag in these effects result in sustained undervaluation.

The effect of these abnormal exportations may well be very harmful for the other countries. But can they be checked by import duties? The imposition by the other countries of special import duties on goods coming from the country with the depreciated exchange can do nothing to remove the influences which are depressing the exchange, and must itself depress the exchange further. It can in fact only check the exports of this country in so far as it reduces its imports, which are already abnormally restricted. It is true that

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if only one of the countries affected by the exchange dumping were to adopt special protective measures, the effect on the exchange might be relatively small, so that this particular country would be able to defend its producers in its home markets. But it could not defend them in the foreign markets, and they would meet all the greater competition there. Both experience and theory show that in this type of case Protection only aggravates the difficulties.

4. In countries with a relatively high standard of living import duties may be advocated as a means of protecting home labour from the competition of the lower paid workers of the other countries. Employers tend naturally to unite with their workers on this issue; and if the employment of labour is subject to especially strict regulation with respect to safety, sanitation, etc., whereby it is made more expensive, the employers are likely to demand offsetting duties on this account also. Amongst home producers the good employer is safeguarded against the undercutting of the "sweater" by trade union action and legislation. On the face of it, it seems anomalous that he should be left exposed to foreign competition of the same type.

On the first question of cheap labour competition the broad answer which has been

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given by many Free Trade economists is to the effect that relative wage levels depend on the relative competitive powers of the different countries, that a country only has high wages if the product of its labour is relatively valuable. It is admitted, of course, that wages in a particular country may be too high for international competition, but it is suggested that this means that the country is assuming the untenable position of demanding more for its products than they are worth.

This answer is only partly correct and displays a confusion between the level of wages and the general level of incomes earned in production. In identifying these two things, it shows, in fact, the lingering influence of the old labour theory of value. The bearing of the relation between the levels of incomes or factor prices on international equilibrium has been discussed in an earlier chapter, and it should be clear that a relatively high level of incomes may only reflect the favourable terms on which the country in question achieves equilibrium. (If we assume that equilibrium is attained, it can mean nothing else.) But it is quite in accordance with modern theory that the relative value of a particular factor in one country should be reduced, if trade is opened with another country in which that factor is less scarce. If the factor in question

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is labour, this provides an argument, from this sectional point of view, for checking the development of such trade.

Caution must be used, however, in concluding that labour's standards are threatened in any particular case. In the first place, as economists have long pointed out, low-wage labour does not necessarily mean cheap labour from the point of view of the entrepreneurs. Low standards of living and low efficiency commonly go together, so that the labour which appears to be cheapest is often in reality comparatively dear. In the second place, it must be noticed that the above argument only refers to the relative value of labour in comparison with the other factors of production. If, as we may presume, the effect of the extension of foreign trade is to increase the total national income, it is wholly possible that a smaller share of a larger total may actually give labour a larger income than the larger share of the smaller total previously enjoyed.

These considerations notwithstanding, we cannot dismiss the possibility that the development of international trade will in certain circumstances prejudice the position of the workers in one of the countries concerned. It is true that if this is the case other classes in this country will at the same time gain the more; and it is also true that the lot of the

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workers in the cheap labour country will be improved. But in the social policy of the first country, these may not be considered adequate compensations. In the case, moreover, in which foreign competition owes its advantage in certain products not to differences in wages paid for the work, but to greater freedom with respect to the conditions in which the work is done, the results of Free Trade may be unsatisfactory from a wider point of view. Differences of social legislation may distort the natural division of functions between countries; the intentions of the more advanced governments may be defeated, in so far as they aim at the general and not merely the local suppression of abuses; and the workers of the poorer countries may also suffer.

Along these lines a case can be made out for limiting certain kinds of foreign competition in the home market, provided the country adopting this policy does not employ an important part of its own labour in producing for export. But unless this last condition is fulfilled, protection by import duties can accomplish but little. This can be seen most clearly if we consider the case of a country with a large export trade which seeks to protect its labour from the competition of the cheaper labour of other countries. Its own labour being relatively dear, the development

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threatened under free competition is that its industry will be diverted into channels in which proportionately less labour is employed. Now so long as the home market alone is important, the scarcity value of labour can be maintained by restricting the entry of the products made with cheaper foreign labour. But the country cannot similarly protect its labour when it is producing for foreign markets. And the more it keeps up the demand for labour for home production, the more it will be compelled to specialize for export purposes in industries which use proportionately little labour. As compared with the position which would exist under free competition, more labour would be used in one direction and less in the other; the net result of protection would simply be, therefore, a more uneven allocation of resources, and a diminished volume of trade, with no benefit to labour. The same analysis appears to apply to attempts to offset by duties the more stringent regulation of labour conditions, in so far as the latter increases the cost of employing labour in general. Only if the burden to be offset is peculiar to particular industries, and these industries are not dependent on export markets, has this type of Protection any prospect of success.

In the years since the War a good deal of attention has been given to an alternative

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method of dealing with these problems—namely, the common regulation of labour conditions by international agreements. The idea is to secure the adoption internationally under the auspices of the League of Nations of the same kind of minimum standards as are enforced nationally in the more advanced countries. There is no doubt that such a policy makes a special appeal to men of generous outlook, because it seems to consult the interest of the workers in the poorer countries as well as those of the workers who are seeking to defend their more fortunate position. This is certainly a condition of its success, but a condition also which limits its scope more narrowly than is sometimes realized. It is often overlooked that conditions of employment which look very bad, judged by the standards of the English or American trade unionists, may be distinctly better than any alternative way of finding a living open (say) to the Oriental worker. To ask the poorer countries to conform to standards which appear suitable to the wealthier countries may therefore amount to asking them voluntarily to deprive their people of a chance of improving their livelihood. This objection would not apply, of course, if the employers of the cheap labour could afford to pay higher wages without raising their prices and curtailing their market, or if the higher

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standard of living resulted in a corresponding increase in efficiency ; but in neither of these cases would international regulation be of any help to the workers of the more prosperous countries. These considerations appear to rule out any attempt at the international regulation of wages, and to leave little hope that much can be accomplished in the way of the international regulation of the hours of work. In the more prosperous countries the workers may wisely decide to take part of their income in additional leisure rather than in an additional supply of the minor luxuries ; it would be a hardship for workers in other countries to be compelled to accept leisure at the expense of the curtailment of their necessities. The proper scope of international regulation would appear to be found in the suppression of abuses in employment conditions which are recognizable by all standards, and from which the individual worker may fail to protect himself through ignorance or lack of foresight. With this would be included the protection of women and children.

5. A few words may be added here on protective duties as a means of raising revenue.

All import duties that are not absolutely prohibitive yield some revenue, and some countries derive a considerable portion of their public revenue from import duties. But in

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so far as the duties are effectively protective they do not yield revenue. Moreover, duties imposed primarily for revenue purposes—whether the idea was to tax the foreigner or the government's own subjects—would fall on different imports from those designed to give protection. On these grounds it is generally held by economists that protective import duties must be judged solely by the benefit or harm of their protective effect. There is one case, however, in which there may be a closer connexion between the two effects of these duties. If the trade and industry of a country is discouraged by what it considers to be excessive taxation, the government may find in duties which discriminate in favour of the home producer the one form of taxation which, whatever its real effects may be eventually, will actually be welcomed. It was in this way that protective and revenue aims were combined in Mr. Keynes' advocacy of a Revenue Tariff for Britain in 1931. The case, however, is a special one, and has a very slender basis unless it can be shown that Protection will really be beneficial. Further, the limitation still holds that duties which promise much in the way of Protection cannot promise much in the way of revenue.

We may now turn to those cases in which the applicability of the two general assump-

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tions of Free Trade theory is questionable; and firstly to the cases in which there may be doubts whether the balance of payments will regulate itself satisfactorily.

The traditional Free Trade view regards all anxieties with respect to the balance of payments as unfounded. With the proper functioning of the gold standard the balance should always be adjusted by contraction or expansion of credit in response to gold movements; and where the gold standard is not in operation, the same effect should be achieved even more directly as a result of movements in the exchange rates. As we have seen in Chapter IV, however, the self-adjusting mechanism is in neither case so infallible as this view supposes.

In the case of free, or paper, currencies, the question is whether any form of intervention is necessary or desirable to relieve the pressure on the balance of payments and prevent excessive depreciation of the exchanges. Normally the depreciation of the exchanges should rectify the balance of payments and go no further than is necessary for this purpose. So far as this is the case, to attempt to check the depreciation is to interfere with the natural remedy for the situation. But in some cases, experience suggests, depreciation may fail to correct the balance of payments and may even make it worse. In cases of this kind the

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presumption is in favour of intervention, if suitable methods can be found.

We must briefly review therefore the various measures of control which may be adopted.

1. *Maintenance of the exchanges round about a certain rate by means of foreign loans.* This method was adopted with success by the Allied Governments during the Great War. In addition to avoiding the dangers of a general loss of confidence in their currencies, it prevented the terms of trade moving violently against the Allies in dealing with Neutrals, as must have happened if the former had had to pay for all their purchases from the latter with current exports. This method has also been used extensively in schemes for the stabilization of depreciated currencies. Its use presupposes, however, the existence of powerful foreign support which is often not available when most required.

2. *The commandeering and sale abroad of foreign securities owned by nationals.* If these holdings are considerable, and if they can be traced or are voluntarily placed at the disposal of the authorities, this is an obvious and effective method of supporting the exchanges.

3. *Special measures to restrict imports.* Exchange depreciation itself discourages imports by making them dearer in comparison with home products. If the demand for certain

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imported luxuries is inelastic, however, it may be useful to supplement the effect of the exchange depreciation by special duties. As an alternative measure, the quantity of certain imports may be limited. This method of restriction has an advantage over the taxation of the imports in the case of commodities which are common necessities up to a certain amount, but luxuries beyond that. But it necessitates further measures for rationing home consumption and often for fixing the quotas of imports from the different exporting countries. As Professor Gregory has pointed out, there is always the danger that the purpose of these import restrictions will be defeated by the diversion of resources from the production of exports to the production of substitutes for the imports. This danger is not very serious, however, if the measures are only temporary.

4. *Export duties.* So long as the foreign demand for the country's products is inelastic, their cheapness will only result in a reduced total value of the exports, despite the increase in their quantity. In these circumstances the imposition of export duties to increase the price of the exported goods to foreigners will improve the balance of payments. But if (as is likely) the inelasticity of the foreign demand is only temporary, so that in time the cheapness of the exports would have led to an

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increase in their aggregate value, then the immediate improvement in the balance may only be obtained at the sacrifice of a more substantial improvement later. If the rate of exchange which would eventually give equilibrium could be computed, export duties to offset the greater part of any depreciation beyond this point might prove useful.

5. *Control of capital movements, particularly restrictions on the export of capital.* Continued depreciation commonly results in a "flight of capital"—a movement to convert funds into other currencies—which in turn greatly aggravates the balance of payments difficulties and causes further depreciation. Attempts have often been made to suppress this development by prohibiting the investment of capital abroad, on long or short terms, without special permission. These restrictions are very difficult to enforce, however. We shall return to this point under the next heading. Here it may be added that it has been found in practice that such measures often have the very opposite effect to that intended, by preventing the tentative repatriation of funds and the temporary inflow of foreign funds which might occur when there is some improvement in the outlook. Thus one of the measures by which M. Poincaré achieved the *de facto* stabilization of the franc in 1926 was the removal of these restrictions.

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6. *Direct control of the exchange market and exchange transactions.* The most comprehensive method of control is that which relates immediately to foreign exchange transactions. In its most complete form this consists in the compulsory pooling of all available claims to payment abroad and the rationing of the drafts drawn against them, private dealings in exchange being prohibited. So far as the scheme can be made effective the rationing authority has control of all foreign purchases, whether of goods or securities. This method also involves fixing a price, *i.e.* rate of exchange, at which the exchange authority buys and sells. There is a danger here that the belief in the official rate may be impaired by the quotation of widely divergent rates in the uncontrolled markets abroad. To prevent this, it may be decreed that all foreign transactions shall take place in terms of foreign currencies, so that there are few dealings in the home currency abroad. This further measure may also serve to prevent foreigners obtaining the home exports at excessively cheap prices. Where the authority is only able to meet a small part of the demand for foreign means of payment, the temptation to evade control is obviously great, and such evasions are hard to check. In the continental countries which have most experience of exchange regulation,

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the technique of control appears, however, to have attained the stage when it can be broadly effective, provided it is not subject to too great a strain.

In recent times there has been much criticism of all foreign exchange restrictions; and clearly when measures of this kind are adopted by a large number of countries at the same time, they can have little effect save to reduce the volume of international trade. In practice, moreover, resort to all these methods of control is attended by the dangers that they will be used to prevent or defer necessary exchange adjustments, or that reliance on them will divert attention from more fundamental measures, such as the internal control of credit. None the less, it appears mistaken to deny that they may have their place as temporary emergency measures.

Short of these more drastic methods of control, much may be done to influence the exchange value of a paper currency by the actions of the central bank. In times of sharp depreciation movements in the bank-rate have only a very moderate effect in attracting foreign balances, and are chiefly important as symptoms of the credit policy which is being pursued internally. But by accumulating a working fund of foreign exchange the central bank may put itself in a position to damp out

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the more violent oscillations of exchange rates and to crush speculative movements before they go too far.

The difficulties which certain gold standard countries have encountered recently in maintaining a satisfactory balance of payments point with less certainty to a need for regulating international transactions. For it may be held that these difficulties were simply due to a failure to allow gold movements to have their normal effects on credit and prices; and it has not been established beyond dispute that the fault has been on the side of the creditor countries. There is, however, the other possible explanation that the price adjustments required for the maintenance of equilibrium on orthodox gold standard principles would in any case have been too large to be tolerable. Whatever may be the truth with regard to recent monetary history, the possibility indicated by the latter explanation is worth considering. It has been suggested earlier that in pre-War times the debtor countries sometimes found themselves in this position, and in his *Treatise on Money* Mr. Keynes suggests that Britain herself is threatened with chronic difficulties of the same kind. Relatively to other countries we are likely to decline industrially in the future. On this account our capitalists are likely to invest abroad on an

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even larger scale than they have done in the past. But to make these investments we shall have to increase our exports relatively to our imports, just when the conditions are, from the nature of the case, most unfavourable. We should thus be faced on the gold standard with the prospect of continued deflation in order to obtain the requisite advantage in money costs.

To meet a situation of this kind, the *Treatise* suggests that it may be necessary to resort to the control of foreign investment and possibly to the control of trade by tariffs.

Temporary embargoes on foreign loans—*i.e.* on the issuing of foreign securities in the London market—were imposed by the moral authority of the Bank of England at certain junctures during the years 1925–31, and were helpful in easing the strain on our balance of payments. If it were attempted to apply this type of measure more permanently, however, as a means of suspending the tendency to an international equalization of interest rates, its purpose would almost inevitably be defeated by the purchase of securities by nationals in foreign markets. Moreover, there is always a possibility that the restrictions of foreign issues will mean a restriction of commodity exports, because the proceeds of the loans would have been spent in the lending country.

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The banks and financial houses may discriminate in favour of borrowers likely to use the money in this way, or make such use the condition of financing the loan; such has in fact been the practice in some countries in which the issuing houses are closely connected with home industry. But it is impossible to take account of all the ramifications of a particular transaction. Country A may lend to country B; country B may spend the money not in A, but in C; but country C may in consequence purchase more from country A; and so on. On the whole it does not appear that measures of this kind would be at all adequate to deal with the fundamental difficulties contemplated in Mr. Keynes' analysis, although they might be of use in more limited ways.

We turn then to consider the possibilities of tariffs as means of avoiding the necessity of deflation.

So far as import duties alone are concerned, there is little that needs to be said. They tend, as has been shown, to make the equilibrium price level higher than it would otherwise have been, and so far to avert the necessity of reducing prices and incomes. But the magnitude of this effect depends, not on the average rate of the duties (20 per cent or 30 per cent or whatever it may be on the value

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of the imports, but on the extent to which the duties turn the terms of trade in favour of the country imposing them. And in general this is slight.

There are theoretically much greater possibilities in the proposal made by Mr. Keynes and others in the First Addendum to the Macmillan Report for a combination of import duties with equivalent bounties on export. This proposal has been little understood, and even economists have so far missed the point as to represent its effect as the sum of the separate effects of import duties and export bounties. With this proposal in mind, it was shown in Chapter III that, as interferences with trade, simultaneous import duties and export bounties tend to cancel one another; and more particularly, that a general import duty of 10 per cent combined with a general export bounty of 10 per cent would have no effect whatever on the course of trade, but would merely necessitate a 10 per cent adjustment in relative prices. In this theoretical analysis it was assumed that equilibrium existed at the time that the duty-cum-bounty arrangement was adopted. In the proposal we are considering, on the other hand, it is assumed that dis-equilibrium exists because prices are too high in a particular country by (say) 10 per cent; and the adoption of the

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plan is put forward as a substitute for a 10 per cent deflation. The course of trade would then be affected as compared with the initial position of dis-equilibrium—that indeed is the aim of the scheme—but only in the same way as it would be affected by the reduction of money costs in the other alternative.

This ingenious idea appears to supply a device by the use of which a country may remain on the gold standard without making the price adjustments which that ordinarily necessitates from time to time—by which, in short, adherence to an international currency standard may be reconciled with complete autonomy with regard to the domestic price structure. When we look more closely at its practical possibilities, however, we find them disappointing. Its immediate application by any country striving with difficulty to retain the gold standard would be likely to encounter obstacles owing to misunderstandings on the part of other countries. Failing to distinguish between export bounties given as part of this scheme and export bounties standing alone, and regarding bounties in general as an unfair assistance to competition, many of these countries would be likely to impose special duties to offset the bounties or even to prohibit altogether the importation of the goods exported

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with the bounty.¹ The Macmillan Report Addendum, referred to, recognized this difficulty, and sought to avoid it by suggesting that in the case of Britain the direct export bounties should be replaced by various forms of indirect assistance to the export industries. It is doubtful, however, whether these would not arouse similar opposition; and once the simple outlines of the scheme are modified, there is considerable danger that the course of trade may be distorted. If we take a longer view, this difficulty might be more satisfactorily disposed of by securing a general understanding of the plan. We can even imagine its adoption as a recognized instrument of international adjustment under standard rules drawn up by the League of Nations. But when we consider the plan as a substitute for price adjustments, and not merely as a means of postponement, we have to take account of the administrative expense involved in collecting money on the imports in order to pay it out again on the exports. This expense must

¹ It should be said that South Africa has recently adopted an arrangement roughly the same as that under discussion, without, so far as I am aware, provoking such counter-measures. This may be due, however, to the character of the exports concerned—raw materials and foodstuffs imported into markets in which they do not compete seriously with home products.

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be expected to continue indefinitely; it will not be appreciably affected by changes which may be made from time to time in the rates of duty or bounty, and no country which decided to rely on this method of effecting its international adjustments could count on its ever becoming altogether unnecessary. It might be difficult to weigh this cost scientifically against the costs of one kind or another involved in the alternatives—the strictest adherence to the gold standard at one rate by the adjustment of internal prices, adherence to the gold standard with occasional revisions of the rate in times of difficulty, entirely independent currency management with variable exchange rates. But from a practical standpoint the certainty of this administrative cost is likely to weigh heavily against the unpredictable risks of the other arrangements.¹

Finally we have to reconsider the other assumption, that under Free Trade the factors of production will be employed as fully as is practicable in the present regime.

¹ In the case of a country whose imports normally exceed its exports the uniform duty-cum-bounty arrangement may leave an excess of revenue to the government, even after the administrative costs have been met. But the real cost of administering the scheme will remain. It would take us too far to discuss here the incidence of the losses which offset both the expenses and the balance which the government gains.

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If we begin by assuming conditions in which there exists general unemployment amongst the productive factors, and assume further that in the absence of Protection this state of affairs is likely to last for some considerable time, it is fairly easy to present tariffs as a remedy worth trying. Although the restriction of imports will tend to restrict exports and add to unemployment in that particular direction, there may still be a net gain both in employment and in production. For the first effect of Protection should be to bring factors into employment in producing substitutes for imports and to increase the incomes of those who provide these factors. So far as these additional incomes are spent on additional purchases of home products, there is compensation for the reduced employment in the export industries ; so far as they are spent on foreign products, exports will not decline. On this showing the increase in employment directly produced by the tariff is a net increase. (This argument implies, I think, that the circulation of money becomes more active, if the quantity of money remains the same ; but such a development is not at all unlikely.) Those brought into employment would be able to consume more, and although the goods previously imported would be obtained at a greater real expense than if they had continued to be bought with exports,

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this is of no significance if the factors employed would otherwise have been wasted.

But in what circumstances is it likely that there will be a general surplus of factors seeking employment? This is somewhat debatable ground, but I think there are only two cases.

1. The general price and income structure may be too high for international equilibrium, so that there is a general tendency for producers to be undersold in both home and foreign markets. (So far as capital is concerned, the incomes of capitalists would be high in relation to the services of their capital, not, I think, because the current rate of interest would be high, but because of high capital values. Actually, the current rate of interest would probably be relatively low in this country, and there would be a tendency for foreign investments to be large. This of course would aggravate the balance of payments difficulties.) But a tariff, as we have seen, can do comparatively little to remedy the balance of payments; and even if it did increase employment this balance of payments problem would still have to be solved. On the other hand, if the balance were rectified either by deflation or devaluation, the abnormal unemployment would disappear.

2. General unemployment is encountered recurrently during trade slumps. In the past,

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however, periods of general trade depression have been limited in duration to a few years and have been followed by times when the scarcity of the productive factors has been abnormally acute. Unless there is reason to suppose that trade has lost its former recuperative powers, there are obvious objections to attempts to remedy the slump by measures which will involve a less economical use of factors over a long period. It may be repeated that import duties afford no protection against the recurrence of slumps.

There remains to be considered the case in which there exists an unemployed surplus, not of the productive factors in general, but of one important class of factor, let us say, labour. We must assume that the unemployment exists because it does not pay to employ the factor fully at the price required for its use—in this case at the level of wages demanded; for if it would not pay to employ it more fully at any price, there can hardly be any ground for intervention. But the case could occur without the general level of incomes being too high for international equilibrium, and therefore without the accompaniment of balance of payment difficulties.

The most obvious remedy for this situation would appear to be a general reduction of wages to the level at which it would pay to

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utilize the whole of the available supply of labour. This is not the place in which to discuss the practical possibility of this course in any particular case, however, so we will assume that this is ruled out, and consider what might be accomplished as an alternative by resort to protective tariffs (or to an increase in existing protective duties). To make a case worth discussing, we will also assume again that in the absence of intervention the situation is likely to endure for a considerable time.

In so far as Protection would raise the general level of incomes—through its effect on the terms of international trade—it would help in two ways : by giving people more money to spend, on labour amongst other things, and by making labour relatively cheap at the old wages. This is assuming, of course, that money wages would not share the general movement, but would remain unchanged ; in fact a general protective tariff would only help in this case in so far as it brought about an indirect reduction of real wages. As the effect of Protection on the general level of incomes would in any case be very limited, more might be expected from a policy of protecting particular industries which employ relatively large amounts of labour, so as to increase the demand for that factor.

To proposals of Protection on these grounds

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the Free Trader might reply, that in practice a general increase in other incomes will excite a demand for an increase in wages as well; and that owing to lack of mobility a disturbance in the demand for labour may increase unemployment, even if the demand for labour of all kinds is increased. Protection must tend to reduce employment in the export industries, and although there may be a more than compensating increase in the demand for labour in other industries, this may be of no avail if the existing supply of labour is of the wrong kind and in the wrong place. These are questions of fact, which would have to be judged in the light of all the circumstances of each particular case. (Often then a decision is difficult. For example, opinions differ as to how far unemployment in Britain in the years before 1929 was due to the difficulty of transferring labour from the declining industries, and how far to the absence of new opportunities of employment.) Another point which must not be overlooked is that a reduction of labour unemployment does not necessarily mean an increase in production. By the terms of the case which we are at present considering, unemployment is peculiar to the one factor labour. If more labour is brought into employment, therefore, the other factors which are needed to co-operate with labour must be

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withdrawn from other uses—and from uses which in the absence of intervention would appear more attractive to the entrepreneurs. Whether the loss on this side is balanced by what is gained through the fuller employment of labour is again a question which cannot be answered in general terms.

It will be seen, I think, that any case that can be made out for Protection along these lines must depend on very uncertain assumptions. We may notice again particularly the assumption that general wage reductions are out of the question and the assumption that, without intervention, unemployment on an abnormal scale would last sufficiently long for it to be worth while to attempt to remedy it by measures which are likely to affect the allocation of resources more or less permanently. But when these and the other necessary conditions are fulfilled, Protection is still not shown to be the best way of achieving the object in view. There are other ways of subsidizing the employment of labour, such as the undertaking of useful development work by public authorities, which are at least as likely to reduce unemployment and are less objectionable in other respects.

This brings us to the point with which this chapter may be concluded. Economists have long recognized in theory that there may be

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cases in which the imposition of import duties would yield a balance of advantages, but they have generally been reluctant to recommend the policy even in these cases, because of certain dangers by which it is attended in practice. One of these dangers is that the restriction of other countries' exports will lead to reprisals and a general embitterment of international relations. Another is that the home producers will unite to take advantage of the opportunity provided by the restriction of foreign competition to exploit the home purchaser. The likelihood of this monopolistic development will vary very much, according to the number of home producers and the degree to which their interests are identical. But the danger is often a very real one, and although the provision of safeguards against exploitation is often talked of in connexion with tariff proposals, experience shows that it is difficult to devise an effective system of control which does not deprive private enterprise of its characteristic advantages. But perhaps the greatest danger is that public policy will be unduly influenced by sectional interests. In some countries tariff legislation has been the occasion of extensive parliamentary corruption. Apart altogether, however, from the cruder forms of bribery by payments to individual members of the legis-

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lature or to party funds, there is the more insidious danger that principles will be sacrificed to the need of conciliating the votes most powerful in the constituencies. It has become a more or less recognized practice that particular members of parliament represent particular interests. Presumably the thorough-going democrat would contend that in a democratic parliament the clash of sectional interests must result in the victory of the interests of the majority. But for various reasons this is not always the case. With reference to tariff legislation, we must notice particularly that those who stand to gain by a particular protective provision may rightly expect to gain *individually* very much more than the majority of the community may expect to lose *individually*. In such a case of a concentrated gain accompanied by a diffused loss, the former will generally provide the stronger incentive to political action, irrespective of the balance of gain or loss to society as a whole. It is true that certain industries, particularly export industries, are likely to suffer from protection a concentrated loss as great as the gain of the protected industries, but this remoter effect of the restriction of imports is not generally appreciated either by politicians, businessmen or the general public. Consequently or the concession of protection

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to one industry, those dependent on other industries are less likely to oppose the measure by reference to its effects on their interests, than to seize the occasion to demand similar protection for themselves. When we remember further, that the removal of a protective tariff, once it has been established, involves serious hardship and dislocation (can it seem worth while to threaten an industry with ruin to save the public $\frac{1}{2}d.$ or $1d.$ a pound?), it is easy to understand how simple and limited tariffs grow into complicated and comprehensive systems; and once the latter stage has been reached it is difficult to find equitable grounds for resisting further demands for protection. From time to time the accumulative effect of the various trade restrictions may produce a reaction on the part of the consuming public, and there will then be a revision of duties downwards. But this is usually the starting-point for a further period for increases. This expansive principle in tariffs is more marked when Protection begins with a general tariff, based perhaps on some fallacious idea of equalizing costs, than when it is given on some special ground, such as we have been discussing above. Yet even in the latter case there is a tendency for Protection to be extended in practice beyond its original limited scope, owing to the difficulty of defining

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the conditions in which the policy may be appropriate in such a manner as to be understood by practical politicians.

These considerations of practical politics are liable to be modified by changes in the standards of public morality and popular education, and by developments in political and administrative technique. But they have not yet lost their force. In recent times there has been some tendency to transfer tariff-making from parliaments to Tariff Boards or independent tribunals, in the hope that these will be less susceptible to the pressure of sectional interests. Actually most of the tariff boards which have been established have been merely advisory and almost completely ineffectual in that. It is possible, however, to set up a small body with power to make final decisions within a general plan laid down by parliament, as has now been done in Britain. It is too early to pass any judgment on the working of the new British system; but on general grounds it may be said that the proper rôle of the independent expert in a democratic community, so far as it is not purely advisory, must be to interpret general principles already laid down or accepted. This would allow a useful place to such a body in drawing up a tariff based on some clear and defensible principle. But if it is placed in the position of having to decide principles,

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or to draw up a tariff without the guidance of a workable principle, its authority is in danger of becoming irksome to the public. Those who are dissatisfied with its decisions will not find it difficult to win sympathy by denouncing it for arbitrariness. Against a general feeling of dissatisfaction, such a body could not hold its own course for long, and in practice the danger would be that, consciously or unconsciously, it would seek to escape criticism by conciliating the more powerful interests—in other words that it would behave in much the same way as the parliament it replaces.

Note on Quota Schemes

Reference had been made above to the use of import quotas in attempts to improve a country's balance of payments. Recently import quotas, or direct restrictions on the quantity of imports, have been advocated as an alternative to import duties in certain cases as a means of giving protection to a particular industry. A few words may be added with regard to this.

A direct restriction of importations below the amount which would otherwise take place will clearly give a competing home industry the same kind of advantage as it would derive from an import duty, and may seem more certain in its operation. For the rest of the

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community the effects will not be quite the same, and will differ according to the form taken by the quota. If the latter simply limits the quantity to be imported within a given period, those who get permits to import or who succeed in importing before the limit has been reached, will sell at the same price as the home producers; the public will pay as much, for a given extension of home production, as under import duties, but the importers will take to themselves the revenue which the duties would have yielded to the government. If, on the other hand, the restriction takes the form of regulating the proportions in which home and foreign products are used by each intermediary at some stage (if, *e.g.*, the miller is not allowed to use more than a certain proportion of foreign wheat), the public will pay less, for a given degree of protection, than under import duties, the price being based on the (weighted) average of the home and foreign cost. The government will not in this case obtain the revenue it would have obtained from import duties, but it may prefer to raise this in other ways. In this form the quota system has recommended itself as superior to import duties in the case of foodstuffs which it is not desired to tax. The drawback to the system lies in its rigidity. If conditions of demand and supply vary

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much, a fixed import quota (whether fixed as an absolute amount or as a proportion) may result in a much greater divergence between the home price and the world price than a fixed import duty, and for this reason the former is more likely to have to be revised abruptly. Thus the greater certainty which it appears to offer the home producer may be in practice largely illusory. Theoretically the direct limitation of imports also affords greater opportunities for a monopoly to exploit the home market. But perhaps this danger is too obvious to be serious.

The system introduced by the British Wheat Act, although based on the quota idea, differs from the foregoing because it does not directly limit the amount of imports, but guarantees a market for a certain quantity of British wheat at a certain price. The scheme is somewhat complicated, but in effect it compels each miller to take up a share of this quantity proportionate to his total output. Under this arrangement the difference between the British and the world price of flour is likely to be smaller than under one by which imports are directly restricted; and if we can assume that the scale on which it is desired to maintain wheat production, or any other industry, for some reasonably long period is definitely known, whatever world conditions may be, this seems the best method of securing the result.

CHAPTER VII

COMMERCIAL TREATIES AND TARIFF BARGAINING

THE subject of tariff bargaining may be conveniently introduced by some account of the accepted forms of trade agreements.

Commercial treaties between two nations may cover a wide variety of subjects. Apart from customs questions, they may deal, for example, with the treatment of one another's shipping in their respective ports, with fishing rights, with the conditions of immigration, temporary residence and travel, with the ownership of property by foreigners, and with the rights of foreign business associations. In earlier times treaty-making was more concerned with securing the right to participate in a particular trade than with the details of customs rates; but since a certain presumption has grown up that trade is in general open to all and that a foreigner will not as a foreigner be deprived of ordinary civil rights, tariff questions have come to be the most important subject of negotiations. With technical progress new forms of international intercourse

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and new conflicts of interest may emerge ; but where these affect a number of countries, the tendency is to regulate them by general international conventions rather than by separate treaties between pairs of countries. We may notice as examples the International Industrial Property Convention for the protection of patents, trade-marks and copyrights, and the Convention relating to International Air Navigation. It must be said, however, that in the relations between the leading powers and the economically more backward countries, agreements giving the former exclusive privileges, such as concessions to build and operate railways or to develop natural resources, are still of great importance.

An agreement between two countries to make mutual concessions in the import duties imposed on one another's products would appear to entail differentiation in the duty imposed on a particular class of imports according to whether the goods are the products of the treaty country or of another country. Now in their commercial policy nations have been at least as anxious to secure that there should be no discrimination against their own products in the tariffs of other countries as to secure reduction in the absolute amount of duty on those products. Accordingly tariff treaties in addition to providing

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for any special concessions on each side, usually bind each country to grant the other "most-favoured nation" treatment. As an example of the most-favoured nation clause in its most general and unconditional form, we may take the article in the 1911 Treaty between Britain and Bolivia :

"The High Contracting Parties agree that, in all matters relating to commerce and industry, any privilege, favour, or immunity whatever which either Contracting Party has actually granted or may hereafter grant to any other foreign state shall be extended immediately and unconditionally to the subjects or citizens of the other Contracting Party ; it being their intention that the commerce and industry of each country shall be placed, in all respects, by the other on the footing of the most-favoured nation." ¹

In its application to customs duties and regulations, the League of Nations has approved of the following more detailed formulation of the clause as a model for future treaties :

"The High Contracting Parties agree to grant each other unconditional and unrestricted most-favoured nation treatment in all matters concerning customs, duties and

¹ Quoted Culbertson, *International Economic Policies*, p. 61.

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subsidiary duties of every kind and in the method of levying duties, and, further, in all matters concerning the rules, formalities and charges imposed in connexion with the clearing of goods through the customs.

“Accordingly, natural or manufactured products having their origin in either of the contracting countries shall in no case be subject, in the matters referred to above, to any duties, taxes or charges other or higher, or to any rule and formalities other or more burdensome, than those to which the like products having their origin in any third country are or may be hereafter subject.

“Similarly, natural or manufactured products exported from the territories of either contracting parties and consigned to the territories of the other party shall in no case be subject, in regard to the above-mentioned matters, to any duties, taxes or charges other or higher, or to any rules and formalities other or more burdensome, than those to which the like products when consigned to the territories of any other country are or may hereafter be subject.

“All the advantages, favours, privileges and immunities, which have been or may hereafter be granted by either Contracting Party, in regard to the above-mentioned matters, to natural or manufactured products origin-

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ating in any other country or consigned to the territories of any other country, shall be accorded immediately and without compensation to the like products originating from the other Contracting Party or to products consigned to the territories of that Party."

Thus if country A enters into the full most-favoured nation relationship with country B, it secures without express stipulation the advantage of any tariff concessions which B has made to other countries, and is also assured of the benefits of any future concessions (within the duration of the treaty) which B may make to other countries. At the same time, if B is on most-favoured nation terms with other countries, any concession which A may specially negotiate with B will also be extended to them. The clause operates therefore to generalize special concessions with respect to a circle of countries, the constitution of which depends, for each country making a concession, on the range of its treaty relations.

Britain, which has been one of the chief upholders of the most-favoured nation principle, has been herself a free trade country until recently, and her future policy with regard to commercial agreements outside the Empire has not yet been decided. In the case of most

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other countries, the adoption of the most-favoured nation clause in their commercial treaties has resulted in what is called a "double line" tariff. In the more usual practice they have a general tariff, which may be called the bargaining tariff and is only applied to the products of countries with which treaties have not been negotiated and to such commodities as have not been the subject of special agreements, and a conventional tariff made up of the rates which have been specially negotiated and have to be applied to the products of all countries enjoying most-favoured nation treatment. The special rates of the conventional tariff are fixed for the duration of the treaties in which they originate. As the most-favoured nation clause generalizes these special rates within the ambit of the treaty relations, a country which wishes to combine the advantages of including this clause in its treaties with a free hand in bargaining will endeavour to arrange that its various treaties fall due for renewal at about the same time.

As an alternative to the general-conventional tariff system, some countries have followed the example of France in adopting maximum and minimum tariff schedules. The maximum schedule corresponds exactly to the general tariff; but the minimum schedule differs from the conventional rates of the other system in

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that the actual rates of duty can be altered at any time. In other words, the country adopting this system promises in its treaties to accord the other party its minimum rates or certain of them, but does not give any undertaking as to what these rates will be. (Perfect freedom is always retained with regard to the maximum or general rates, since they are independent of treaties.) This system, in which all the rates are autonomous, has the advantage from the protectionist standpoint that the duties can be adjusted at any time as may seem desirable for the purpose of safeguarding home industries. But the concession of a variable minimum schedule is of less value to other countries than the offer of the same present rates conventionalized for a period, and is therefore less effective as a bargaining counter. As originally devised, the system afforded two possibilities in the duties to be applied: they were either those of the maximum schedule or those of the minimum schedule. Then once the minimum rate on a particular commodity had been granted to one country, it had automatically to be granted to all other countries enjoying most-favoured nation treatment. To obtain greater latitude in bargaining, France has modified her system by widening the margin between the maximum and minimum rates and by granting her concessions in the

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form of a percentage of the difference between those rates. Thus a 50 per cent concession would mean that the rate to be applied was always the middle point between the maximum and the minimum rates, whatever those rates might be at the time. In this way the possibility of making further concessions in respect of any commodity (up to 100 per cent of the difference between the two rates), in exchange for new advantages from other countries, has been reserved.

To the principle that a country which has been promised most-favoured nation treatment is entitled to receive the fullest trade privileges allowed to any country, there are certain more or less recognized exceptions. Sometimes these are expressly provided for in the treaties, but sometimes they are held to be implied.

(a). *Frontier Traffic.* The most general exception is that which allows freedom of trade within a restricted zone on either side of a frontier. The actual line followed by international boundaries is commonly very arbitrary from an economic point of view, and the strict maintenance of customs barriers would accordingly be a great hardship to the inhabitants of frontier districts. Hence an apparent violation of the most-favoured nation principle in favour of adjacent countries has to be allowed within limits.

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(b). *Colonial Preference.* In conceding most-favoured nation treatment to foreign countries, the United Kingdom expressly reserves the right to give preference to her Dominions and Colonies ; and in making treaties on behalf of her colonial dependencies she reserves the right to receive preference over all foreign countries. In their commercial treaties, the British Dominions make a similar reservation in favour of the United Kingdom. The same practice is followed by the United States, France, Italy, and Spain, but not by Holland.¹

(c). *Regional Exceptions.* In a number of cases exceptions similar in principle to the colonial preferences have been made in favour of the special relations between neighbouring countries or countries having historical or racial connexions. Such exceptions are the privileges granted *inter se* by Spain and Portugal, by the Scandinavian countries, by the Baltic States, by certain Balkan countries, by certain South American countries, by Central American countries, and by the United States and Cuba. Moreover, Spain reserves to herself the right to give special privileges to the Latin American countries, and Portugal to

¹ R. Riedl, "*Exceptions to the Most-Favoured Nation Treatment*" *Report to the International Chamber of Commerce*, pp. 19-20. P. S. King & Sons, 1931.

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Brazil.¹ The tendency is for this class of exception to be extended, weakening the effect of the most-favoured nation clause.

(d). *Customs Unions*. There has been some uncertainty as to whether a customs union could be formed between countries, some of which had contracted to give most-favoured nation treatment to countries not party to the proposed union, without a violation of this obligation. In some treaties this contingency has been expressly provided for, but without this it may now be regarded as established that the exception of such unions is implied.

Certain special forms of trade restriction of fairly recent introduction have raised new problems in the interpretation of the most-favoured nation clause. May, for example, a country which has been promised most-favoured nation treatment be subjected to special anti-dumping duties or duties to offset exchange depreciation? Again, how is the principle to be applied to the restriction of imports by quotas? It cannot be said that these problems have yet been solved in a manner generally recognized as fair and reasonable, and it is very desirable that international understandings should be reached with regard to them.

Apart from open exceptions, there are certain

¹ R. Riedl, op. cit., pp. 13-14.

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possibilities of violating the spirit of the most-favoured nation clause by veiled discrimination. The readiest means available for this purpose is manipulation of the customs classification. The exports of different countries, although economically competitive, may have different physical characteristics. It is therefore possible to discriminate against the products of one of them by so constructing the classification that they fall into a class with a relatively high duty. Since all the countries would be charged the same duties on each class, this would involve no literal or legal violation of the most-favoured nation clause. Another possibility is to introduce discrimination under cover of sanitary regulations. Accusations have been made from time to time on both these scores, and are often hard to prove or disprove. There can be no question that the existence of these possibilities of evasion is a serious drawback; but it cannot be said that they have prevented the clause from exercising a powerful influence for the suppression of tariff discrimination and the equalization of conditions as between foreign competitors.

The foregoing account of the meaning and operation of the most-favoured nation clause is based upon the interpretation which has always been placed upon it by Britain and has

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been accepted by most European countries at any rate since the middle of the last century. In the United States and certain countries—chiefly South American—which followed the lead of the United States, however, a different view prevailed until a fairly recent date as to what the clause should mean. The American view was briefly that the existence under treaty of most-favoured nation relations did not require one country to extend to another *gratuitously* concessions which had been given to a third country in exchange for counter-concessions. At first a considerable amount of confusion and controversy was occasioned by the fact that the United States interpreted the general most-favoured nation clause in use in all treaties in a sense different from that attached to it by the European countries ; but latterly these misunderstandings were avoided by the express incorporation of the American view in her treaties. The following is a typical example of the *conditional* as opposed to the *unconditional* version of the most-favoured nation clause :

“ The High Contracting Parties agree that, in all that concerns commerce and navigation, any privilege, favour or immunity which either Contracting Party has actually granted, or may hereafter grant, to the

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citizens or subjects of any other state shall be extended to the citizens or subjects of the other Contracting Party *gratuitously, if the concession in favour of that other state shall have been gratuitous, and on the same or equivalent conditions, if the concessions shall have been conditional.*"

There is little doubt that this interpretation commended itself first on grounds of fairness. The concession which one country obtained with a *quid pro quo* could not justly be claimed by another country without compensation. The most that could be demanded by a third country on the strength of the most-favoured nation clause was, as the American authorities maintained, the opportunity to make a similar bargain. The conditional version of the clause has also been favoured as a more useful bargaining instrument, since it does not entail "giving away" concessions to "third parties." It is on this ground that France, departing from her previous practice, has shown a preference for the conditional clause since the War. Finally, it may be contended that strongly protectionist countries are more likely to make concessions in their tariffs if these are not automatically generalized for a number of exporting countries.

A serious practical difficulty in the applica-

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tion of the conditional form of most-favoured nation clause is to weigh the value of the different tariff concessions which may be offered. When one country has obtained a favour in return for a reduction of its duties, it is seldom possible for another country, with an entirely different tariff system, to qualify for the same favour by making an exactly similar concession. If it seeks to share the privilege, it must therefore offer an *equivalent* concession. But opinions often differ in measuring the equivalence, each country tending naturally to value every concession from its own point of view. Moreover, several concessions are often made simultaneously by each party to a treaty, so that it is impossible to say exactly what has been paid for an individual concession. In some cases the United States has maintained that the value of a concession given to her depended on the peculiar relations between herself and the other party, and therefore could not be matched by another country. In any case, if under the most-favoured nation clause a country has to purchase each concession made to it at a price satisfactory to the other party, its position is not substantially better than that of a country which has no such treaty rights. On this interpretation, in fact, the promise of most-favoured nation treatment assures the country to which it is

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accorded of no more than immunity from malicious discrimination—in other words, of treatment with ordinary goodwill.

The conditional form of the most-favoured nation clause itself received a new interpretation towards the close of the last century with the adoption in American policy of the principle of “reciprocal equality,” according to which the duties to be levied on a particular country’s export to the United States should bear a fair relation to the duties levied by that country on imports from the United States. This principle was applied by imposing penalty duties on the chief exports of countries whose duties on United States exports were considered too heavy, or by granting concessions from the general rate to countries whose treatment of United States exports was considered satisfactory. (The distinction in method is purely formal, for in the latter case the general rates were raised to provide for the rebate.) This meant that the import duties were to discriminate between countries of origin, not on the basis of *ad hoc* bargains, but on the basis of the actual treatment of imports from the United States, whether as a result of special concessions or not. It will be found, I think, that the formulation of the conditional clause given above can be read so as to permit this, and it may be contended that this is the fairer interpretation,

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particularly in relation to the free trade and low tariff countries whose liberal policy leaves them little or no scope to make concessions. On the other hand, given at the same time the traditional American view that the level of a country's tariff is a purely domestic matter, it was somewhat difficult to reconcile these discriminations with the general intention of the most-favoured nation clause. This interpretation avoids the difficulties of measuring equivalence of concessions, but, if applied consistently, it would involve possibly greater difficulties in reaching standards of reciprocally equal treatment.

As the United States has been the chief exponent of the conditional version of most-favoured nation rights, it may be of interest to review in broad terms her experience in commercial policy. At first she succeeded in obtaining by treaty fairly substantial advantages, particularly with regard to navigation rights. Later, however, throughout much of the nineteenth century, she played little part in active bargaining, apart from the negotiation of a Reciprocity Treaty with Canada. Her exports received most-favoured nation treatment in most markets, but this was not the result of bargaining, but of other circumstances: of the policy of other countries, of the character of her exports (food-stuffs and

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raw materials) and of the fact that she herself applied a uniform (single line) tariff without discrimination—of the fact, that is to say, that she did *not* bargain. During this period her tariff was framed and maintained almost solely with a view to protection. This attitude was modified by the bargaining provisions in the Tariff Acts of 1890 and 1897, based on the principle of “reciprocal equality.” This principle was only applied in certain directions, however, and the only substantial result was to secure certain exclusive duty concessions from Brazil by the threat of a penalty duty on her coffee. For a considerable period before the War, therefore, the conditional principle, although consistently asserted, was not of much practical importance. Since the War the United States has had to reconsider her commercial policy very carefully. Her export interests—particularly in manufactures—having grown very much in importance, she has become more concerned with the conditions of competition in foreign markets. At the same time there has been a disposition for other countries to adopt more aggressive policies. Finally, her own policy with regard to her home market has been exceptionally protectionist. Taking into account all these circumstances, it is not surprising that the United States has come to the conclusion that the principle of

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equality of treatment with her competitors is the one which is most likely to serve her interests in negotiations with other countries. But this has meant a complete change in her attitude and a willingness to give as well as receive *unconditional* most-favoured nation treatment. Although her tariff still contains some provisions based on earlier and inconsistent views, this has been her declared policy since 1923.

Thus the conditional form of the most-favoured nation clause has lost its traditional upholder. It is true that in Europe there has been some tendency during the post-War years in the opposite direction, particularly in French policy. (In fact, as hinted, this has had something to do with the change in American policy.) But even France has not been able to avoid incorporating the unconditional form of the clause in some of her treaties.¹

With these technicalities in mind, we may now turn to examine the possibilities of tariff bargaining.

Perhaps it will be as well to explain that the

¹ Professor Viner has pointed out that the accord of unconditional M.-F.N. treatment to one country makes the conditional clause in other treaties in effect unconditional. For once concessions granted conditionally to some other country have been extended gratuitously to this one country, they can be claimed gratuitously by all other countries.

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form of bargaining with which we are at present concerned is that which consists in imposing or raising duties, not because it seems desirable to give protection to home industry, but with a view to securing a reduction in the duties of other countries in exchange for their withdrawal or reduction to the previous level. Logically the same type of bargaining occurs when a country which recognizes that it would be in the interests of its own economy to reduce its duties, makes this reduction conditional upon tariff concessions from other countries. On the other hand, a different sort of bargaining takes place when a country abandons a measure of protection which it considers in itself advantageous for the sake of obtaining a concession in duties for its export industries. For want of better terms, we may designate the former sort of bargaining "aggressive" and the latter sort "conciliatory."

Aggressive bargaining has been practised extensively by the continental countries, and it cannot, I think, be disputed that its general effect has been harmful. Tariffs have been raised on all sides for bargaining purposes, each country believing that its bargaining position would be the stronger, the heavier the penalties which it was in a position to impose on the trade of other countries; and this competitive raising of tariffs has seldom been com-

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pletely undone with the subsequent conclusion of trade agreements. The final effect has thus been to raise rather than to lower the duties. In addition, trade has suffered from uncertainty and dislocation. Tariffs framed with an eye to bargaining are even more unstable than those which serve purely protectionist aims, and tariff bargaining has often led to tariff wars, in which normal trade relations are completely disrupted. Finally, when the most-favoured nation clause has not been in full and unconditional operation, bargaining has resulted in the discriminatory treatment of the products of different countries, thus further distorting the course of trade.

In the absence of a general and enforceable understanding against the practice, however, the recognition of these general disadvantages will hardly prevent a particular country from resorting to bargaining if it sees a prospect of securing a net advantage for itself by this means. In what circumstances is this likely?

In principle country A should be in a position to apply pressure successfully on country B, if the trade between them is of greater importance to B. In practice, however, the situation is seldom so simple. In the first place, if the products which constitute B's chief exports to A are also imported by A from other countries, the use of A's bargaining power may be restricted by

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the existence of commercial treaties. If A has promised conditional most-favoured nation treatment (in the usual sense) to all the countries supplying these products, it will be free to drive its bargain with B ; but unless it is in an equally strong bargaining position against the other countries, it will find that it is restricting its trade with them and perhaps risking reprisals in their tariffs. If, on the other hand, it has unconditional most-favoured nation relations with all the countries, it would be able to extend the concession from the bargaining tariffs which it may eventually make to B to the other countries gratuitously ; but in that case B would be encouraged to resist by the knowledge that A would be injuring its own trade with other countries during the bargaining period, and that A could not come to terms with these other countries without giving B the same advantages.

These restrictions would not operate, however, if A's treaty obligations towards B had lapsed or could be terminated ; for then, whatever its tariff treatment of other countries, A could make the renewal of most-favoured nation relations with B conditional upon securing the concession it required. Sooner or later, therefore, the issue can be brought to a direct trial of strength.

If the duties which A desires to get reduced

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have been adopted by B deliberately for the protection of its own industries, that country will naturally be disposed to offer what resistance it can to A's demands. In estimating the seriousness of this resistance, we must bear in mind that so far as its effects in the restriction of trade, both imports and exports, are concerned, the bargaining tariff simply aggravates the effects of the protective tariff against which this is directed. If the protection was at all rationally conceived, it was intended to reduce the country's dependence on its exports. In any case, in a protectionist country there is usually a strong party which desires more protection and a higher degree of self-sufficiency, to whom the effects of a tariff war would not be altogether unwelcome. Other sections, probably constituting a majority, will not regard the consequences with like equanimity. But their attitude is liable to be influenced by feelings of national pride. An aggressive tariff policy directed against a particular country (theoretically there is more chance of bargaining successfully with one country) naturally tends to excite resentment; it makes dependence on the export market in question more irksome, and generally induces a state of mind unfavourable to the sober calculation of prospective gains and losses. Finally, if the bargaining tariff does come into

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operation for any time, the restriction of trade is likely to give rise to vested interests on both sides which will hinder the resumption, let alone the extension, of the previous commercial relations. In view of all these considerations, it requires a very decisive advantage in bargaining to make the policy of breaking down protective barriers feasible. Taking into account further the sacrifice entailed in political as well as commercial goodwill, it is not surprising that the policy has seldom been pressed to a successful conclusion. On the other hand, if some countries make a practice of tariff higgling, it may be difficult for other countries to avoid at least making a show of bargaining. This point is well illustrated by the following statement made by the Swiss Federal Council, in justification of the adoption of a higher tariff in 1921 :

“ Foreign countries oppose to us tariffs whose rates are, so to speak, much higher than ours. When we ask for the reduction of these rates—and we must ask reductions in the interest of our export industries—they demand of us concessions which, no doubt, might be made, in a sufficient measure, from a general tariff but which cannot be made from a working tariff. While the negotiators of the foreign state finally under-

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stand our particular situation and take our working tariff for what it is, that is to say, for a minimum tariff, the public opinion and Parliament of the country in question, by whom the structure of our tariff is less well known, do not see the situation as it is. They compare the reciprocal concessions which have been made upon the basis of unequal tariffs and they find our concessions insufficient.”¹

In this respect the position of countries with moderate non-bargaining tariffs may be more difficult than that of completely free trade countries, from whom it is obvious that no concessions can be asked.

Aggressive bargaining has greater and more dangerous possibilities in another type of case : when it is directed, not towards breaking down the protection given to home industries, but towards securing advantages as against other foreign competitors—in other words, towards obtaining privileged concessions from a tariff which is in effect mainly a revenue tariff. A good example is furnished by the special duty reductions which, as already mentioned, the United States obtained from Brazil by means of the

¹ Quoted by Mr. W. T. Page in his Memorandum on European Bargaining Tariffs, prepared for the 1927 International and Economic Conference. League Economic and Financial series, 16. 7, ii. 28.

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threatened duty on coffee in the Tariff Act of 1897. Presumably because Brazil adopted the conditional interpretation of the most-favoured nation clause, the concessions were not generalized; and indeed until 1920, when some of them were shared with Belgium, they were enjoyed by the United States alone. Thus United States flour was favoured by a 30 per cent reduction in the duty as against Argentine flour, and United States watches by a 20 per cent reduction as against Swiss watches.

Switzerland did not attempt to retaliate against Brazil for this discrimination against her products, and possibly could not have retaliated successfully whatever her tariff policy. But however that may have been, the fact that discriminatory advantages could be obtained in this way must suggest that countries whose general policy does not allow them to bargain may sometimes be placed at a real disadvantage in international competition. In practice, however, this possibility is probably not as serious as it at first seems. The case cited was an unusual one, and it is very noteworthy that in 1923 it was voluntarily terminated by the United States herself. Having adopted the principle of unconditional most-favoured nation treatment as a means of securing that there should be no discrimination against her own goods in foreign markets, she

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realized that she could not continue to ask for special favours in Brazil. It is also to be noticed that free-trade Britain has always received most-favoured treatment of her products in almost all markets, although discriminatory classification may have done something to undermine this position in recent times.

What possibilities there are for aggressive bargaining are seen to depend almost entirely on the absence of the obligation to give most-favoured nation treatment or on its restricted interpretation. If, therefore, it is agreed that the general effects of such bargaining are bad, equality of treatment, as assured by the unconditional most-favoured nation clause, is the principle which one would wish to see universally recognized. From the point of view of a country which wishes to experiment with bargaining, the conditional form of the clause may well seem more logical ; but it is precisely the advantage of the unconditional form that it restricts bargaining and makes participation in the process unnecessary. Of the two forms of the conditional interpretation, the "reciprocally equal treatment" form is much to be preferred from this point of view to the "equal concession" form, because it does not penalize those countries which pursue a free trade or low tariff policy. But it shares other

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serious disadvantages ; it is almost impossible to apply in a way which would satisfy all parties as equitable, and therefore it is likely in practice to lead to tariff disputes and discriminations. The most serious limitation of the unconditional form of the clause in this direction is the possibility of evasion, particularly by manipulation of the customs classification. A uniform classification cannot be regarded as attainable owing to the divergencies of the protectionist aims of the different countries. Something might be done, however, by conventions providing in the last resort for arbitration, to secure that the variations in the classifications are solely determined by domestic conditions.

It may also be objected to the unconditional clause that it is likely to hinder what I have called "conciliatory bargaining," or agreements to make mutual reductions in tariffs which have been genuinely adopted for protection. Exclusive arrangements of this kind are a further subject for our consideration, but as the effects are the same whether the concessions are made by isolated bargains or as part of a more general arrangement differentiating the trade between the countries concerned from their trade with the rest of the world, we may proceed at once to discuss the possible advantages and disadvantages of the latter

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The arrangements to be considered range from complete customs unions, in which all duties are abolished on trade between the members, through definite preferential systems, such as that existing between the parts of the British Empire, to the looser understandings which are just recognized as regional exceptions in the application of the most-favoured nation clause. We shall be concerned here, however, not with their constitutional characteristics, but with their economic effects.

For purposes of analysis it will be convenient to distinguish between two cases which cannot always be distinguished in actual practice. These are the case in which differentiation between the parties to the arrangement and the rest of the world is brought about by the reduction or abolition of duties in trade between the former, and the case in which it is brought about by increased duties on trade with the latter.

(1) In the former case the reduction or abolition of duties in the trade within the group of associated countries must, according to our general principles, be of advantage in so far as it leads to increased specialization between these countries, to a movement away from the artificial self-sufficiency engendered by tariffs. On this ground the formation of such unions is often advocated as the best practicable step in the direction of Free Trade.

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But there is another side to the question, concerned with the effect of the arrangement in diverting trade which would take place in any case from non-member countries to member countries. For discrimination, or the differential treatment of the products of different countries, will tend to distort the course of trade, even if it is brought about by a reduction of duties in favour of certain countries. This distortion is clearly a disadvantage from the point of view of the non-member countries and from the point of view of the world economy; and, although this is not quite so obvious, it will also be a disadvantage for at least some of the members. For the sake of simplicity, let us say that there are just two countries party to the union, A and B. As a result of the conditions established by the union, A obtains from B commodities which previously she imported from C and D. The consumers in A will probably be able to buy these commodities more cheaply, but this does not in itself show that the country has gained, because the government will have lost in revenue in respect of these imports. If B's exports of the commodities in question were previously more than sufficient to cover A's requirements (quality being uniform), then, in the absence of monopolistic agreements amongst B's exporters to exploit A, the consumers in A will benefit by

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a reduction in price equal to the whole of the remission in duties. Assuming that the same applies to the imports which B obtains from A instead of from C and D, the effect of the union in this direction is simply to cause a re-shuffling of trade (which may or may not involve additional transport costs) and a substitution in each country of new taxes for customs duties. So far there is not much gain or loss to set alongside the gain from the increased specialization between A and B. But it is unlikely that this position will exist with respect to all or even most of the commodities affected by a comprehensive union—if it did indeed there might be little demand for the union. If B did not previously export enough to meet A's requirements, it may increase its exports to this amount under the stimulus of a higher price, in which case the consumers in A will not get the full benefit of the revenue sacrificed by their government; or it may not be able to do this, in which case the A consumers will have to pay the same price as before in order to cover the cost of importing some of their supply from C and D, and will get no benefit at all from the remission of duties on the part of the supply which comes from B. Against these losses on A's side, there would appear to stand gains to B through the increased foreign demand (in A) for the

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output of her productive factors; and it might also appear that, if the situation were again reciprocal, A would get compensation for the above losses in B's increased demand for her products. This view, however, would be fallacious. If B does gain at all it is because the deflection of demand by discrimination enables her to exchange her output for that of A on better terms; and in this case A clearly loses. Thus one country inevitably loses. But if there is no change in the terms on which A and B exchange the products of their resources, both countries will lose because on each side those resources are being used less economically. Taken together the two countries must lose on balance, their collective position being analogous to that of a single country which restricts its foreign trade by giving a bonus on home production.

(2) In the second case, in which differentiation is produced by raising duties against outsiders, the advantages of greater freedom of trade and more extended international specialization are entirely absent, whilst all the above disadvantages are present. The analogy for the position of the group collectively in this case is with a single country resorting to higher protection.

As indicated already, the customs unions or preferential relations which exist or are pro-

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posed are likely to have a mixed character from the point of view of the foregoing analysis. None the less, the analysis provides us with criteria for judging such arrangements.

1. Such arrangements are to be condemned in so far as they entail an increase in duties against outside countries. In a mixed scheme there is a strong presumption that the result of the whole will be harmful if the duty increases are at all important. This is not to say that one or more of the countries party to the arrangement may not gain. But such a gain means a further loss to the other parties, and in this form the arrangement is not likely to be durable.

2. Such arrangements are good in so far as they result in breaking down the protection of home markets, thereby increasing specialization: harmful in so far as they divert international trade from its previous channels. It would follow that the results are most likely to be beneficial when these customs arrangements are made between countries producing very much the same kinds of commodities, and most likely to be harmful when made between countries producing entirely different things. This conclusion may be surprising to some, and perhaps disappointing; for it is often the

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complementary character of the countries concerned which makes a projected union seem attractive. The fact is that people are more apt to see the advantage of being assured a good market for their products than to realize the disadvantage of being restricted in their purchases.

A further point suggested by Professor Virer is that customs unions are likely to be beneficial when formed between contiguous countries. "As a rule, customs unions probably constitute a forward step towards freer trade, since such unions are commonly established or proposed between neighbouring countries, and the trade which would result if the tariff wall is removed between two adjoining countries is likely to be trade which in large part would persist if the duties on imports from third countries were also abolished."¹ The point is, I suppose, that, transport costs being less, a given import duty is *relatively* heavier on imports from near countries; or it may be rather that protective tariffs are usually fixed at a level to keep out the nearest—and therefore strongest—competitors. As a rule, adjacent countries are also likely to have many products in common.

¹ *Index*, volume VI, number 61, p. 11.

CHAPTER VIII

THE PROSPECTS OF INTERNATIONAL TRADE

DURING the nineteenth century and down to the outbreak of the Great War, the great advances achieved in material prosperity went hand in hand with an extension of international trade. The period was characterized by the opening up of new regions as sources of raw materials and foodstuffs by means of capital provided by the older countries. Although the statistics required for the comparison are lacking, it seems safe to say that international trade increased not merely absolutely but relatively to production and trade in general.

The War rudely interrupted this development and left effects which have interfered with its resumption. The curtailment or suspension of the belligerents' trade during hostilities compelled other countries to fall back on their own resources. In some part the United States was able to supply the deficiency created in world markets by the falling off in European exports; but in many countries the circumstances induced a development of home manu-

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facturing industries to replace the imports which had become difficult to obtain. In some cases the interruption of trade may have operated as the desirable sort of Infant Industry protection in accelerating right and necessary developments. In other cases, unfortunately, industries were established with no real prospect of being able to stand against open competition in normal circumstances; and these have been continued since with the support of protective tariffs.

The creation of a number of new states at the termination of the War also had the effect of hindering trade and inter-regional specialization. It inevitably meant the erection of new customs barriers, and actually these new tariff systems tended to be exceptionally restrictive, owing to the efforts of the young states to increase their political independence by making themselves as far as possible economically self-sufficient.

International trade in general was much hampered immediately after the War by the derangement of currencies and by a drastic restriction of imports by prohibitions and licensing systems. In these respects, however, steady improvement was made until the onset of the present economic crisis. By 1926 most currencies had been stabilized in relation to gold, and the special restrictions on foreign

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trade had generally given place to the more customary method of regulation by duties. These duties were generally higher than those in force before the War, although the calculations made by the League of Nations experts, comparing tariff levels in 1913 and 1925, show that on the whole the difference was less striking than might be imagined. In any case commercial policy was not as settled as it had been before the War. A number of commercial treaties were negotiated, but they were mostly terminable at relatively short notice. Moreover, bargaining tariffs were commonly put into operation before treaties had been negotiated.

The circumstances which checked world trade also tended to restrict world production. But in the latter recovery and progress, measured by pre-War standards, was achieved more rapidly than in the former. According to the calculations of the League Economic and Financial Organization, the world production of agricultural raw materials and foodstuffs was in 1925 18 per cent greater than in 1913. It is more difficult to estimate the production of manufactures, but it is at any rate clear, that outside Europe greater progress had been made in this respect during the interval 1913 to 1925 than in raw materials. On the other hand, world trade only showed

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an increase of about 8 per cent, when allowance is made for the change in prices, and apparently this figure needs further correction to take account of the fact that the creation of new frontiers has given an international character to exchanges which were previously domestic. During the following three years, 1926-8, international trade grew more rapidly, as rapidly in fact as the production of agricultural raw materials and more rapidly than that of foodstuffs.¹ But manufacturing production almost certainly increased still faster, and there can be little doubt that in 1928 a smaller proportion of products of all kinds entered into international trade than in 1913. With the world-wide depression which began in 1929, there has been a great shrinkage in both world production and world trade, but the latter has suffered in the greater degree.

The relative decline of international trade in the last years can be confidently attributed to the increased restrictions to which it has been subject. Particularly since the development of the international financial crisis in 1931, foreign trade in all but irreplaceable essentials has been practically strangled by the devices which each country has adopted in

¹ For facts and estimates with respect to all these matters, see Loveday, *Britain and World Trade*, articles 1 and 2.

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turn in the hope of improving its balance of payments. But is the smaller (relative) importance of international trade in 1928, in comparison with 1913, also to be explained wholly by increased restrictions ?

This raises the interesting but speculative question of whether it is to be expected that international trade should always increase in importance with economic progress. Although there is little prospect of reaching a definite answer, it may be worth while to make a brief survey of some of the main factors involved.

One fact of obvious importance is that in many countries, and those the wealthiest, the population has ceased to increase rapidly and is tending rather to become stationary. So far as this is the case, any increase in the aggregate wealth of the world will be an increase in wealth per head. This circumstance must necessarily affect the character of production, and in particular is likely to mean a decline in the proportion of productive resources devoted to raising the essential food-stuffs, since individuals do not appreciably increase their consumption of these once a certain level of prosperity has been reached. Thus the commerce in these commodities, which accounted for a considerable part of the growth of international trade in the last century, is likely to be of less importance, and

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has indeed already declined relatively. But will the diversion of resources to other purposes result in more, or in less, foreign trade?

One view on this question is that the more varied are the wants which man is in a position to indulge, the greater is the scope for international specialization. As Mr. Love-day expresses it: "... international trade becomes more and more imperative as income increases. The great commercial nations are not only rich because they trade, they trade because they are rich. Impediments to trade impede progress the more the greater the progress already achieved. It is the rich who cannot afford the privilege of high tariffs, not the poor."¹ But the correctness of this view is not altogether certain. The surplus income, over and above what is required for necessities, is largely spent in connexion with recreational activities. So far as these take the form of foreign travel—as appears to be the case to an increasing extent—the result is virtually a form of international trade, and at any rate necessitates international payments. But to a very large extent they call for the provision of services of one kind or another at home. The popularization of motoring has given rise to an important international trade in petrol and rubber; but it has also occa-

¹ *Prison and World Trade*, p. 72.

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sioned the employment of a large number of men as mechanics and petrol-pump attendants in the consumers' own country. It is at least possible that the expenditure of the modern motorist gives more direct employment to home labour than the expenditure of the Victorian on his larger family. It would be useless, however, to examine this particular case more closely, for it is only one case and may lose its importance. The one thing that is definitely known about luxury expenditure appears to be that it is variable and uncertain.

We have to consider, in addition to the direction likely to be taken by consumers' demands, the probable character of the technical improvements which may contribute to economic progress. If the latter take the form of improvements in the long-distance transportation of goods, they are clearly likely to increase the importance of international trade. The same result will occur if the improvements accentuate the advantages of production on a very large scale in a particular region, or call for the utilization of resources which are very unevenly distributed as between countries. On the other hand, they may take the form of making it possible to use a greater variety of resources for a particular purpose, thus mitigating the comparative disadvantage of certain countries in certain

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branches of production. During the nineteenth century technical progress was chiefly of the former types. The changes which have taken place during the short period which has elapsed since the War appear to be rather mixed in character. In the transport of goods improvements on the mechanical side have been more marked in short-distance land transport than in long-distance transport, or in ocean transport; but on the other hand, modern refrigerating processes have made possible new forms of long-distance international trade, *e.g.* in fruits and dairy produce. In production some of the improvements have been of the kind to favour the specialization of certain regions of the world; thus in wheat production the advantages of the new countries over the old appear to have been increased. But improvements of the opposite tendency have also been very important. The production of coal for export has been curtailed by the increased use of both water power and lignite in the generation of electricity; and at the same time the relative advantage of many coal-producing countries in manufactures has been diminished. In turn it is possible that coal will be made to yield substitutes for the petrol and fuel oils now obtained from a few countries. It is as impossible to forecast the direction in which

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technical advances will be made as to foresee changes in demand.

Finally, we have to consider the effects of changes in the mobility of the factors of production. Improvements in passenger transport, in the means of verbal communication and in medical science—in the control, for example, of tropical diseases—must tend to increase mobility. How will this affect the relative importance of international trade?

Foreign investment may lead directly to international movements of goods both in order that the investment may be made and in order that the interest on existing investments may be paid. But the payments in connexion with international investment may cancel out, and one cannot make any general statement as to whether a given change in the amount of foreign investment will increase or decrease the movement of goods. What we are concerned with here is the effect of a changed distribution of the factors of production on the exchange of goods between countries.

In an earlier chapter it has been shown that international trade depends on the uneven distribution of the productive factors, and that therefore the movement of goods is in a sense a substitute for the redistribution of the factors. From this it may appear to follow

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that increased mobility in the factors would necessarily reduce the importance of international trade. Absolutely the volume of such trade might increase with the general increase in wealth, but relatively to production and domestic trade it ought apparently to decline. On the other hand, historical experience shows that the result of large migrations of capital and labour has often been the opposite—namely, the development of great export industries in countries previously carrying on a subsistence economy. The explanation is no doubt that these countries possessed natural resources which could not be utilized properly, if at all, with a scanty supply of capital and labour. From a theoretical point of view, it is possible to say that these resources were economically non-existent until the migration of capital and labour took place, and that in making them available, the migration rather increased than diminished the inequalities in the supply of available factors. From a practical standpoint the question is whether the movements of capital and labour will be chiefly between countries which are already using the best of their natural resources, or between some of these countries and other countries whose natural resources have still to be developed. In the latter case, international trade may be expected to increase in importance if

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the undeveloped resources are richer than, or different from, those of the more developed countries.

These considerations yield no definite conclusion. They certainly do not show, let it be said, that international trade will not increase in importance. The farthest they go in that direction is to throw some doubt on the inevitability of any such tendency, and to discourage expectations of a *steady* relative growth of international trade.

Whatever the natural tendency in this matter, the general arguments in favour of allowing this tendency to take its course will remain unaffected; and if we turn from the longer views which we have just been taking to the more immediate outlook, the problem of reducing the restrictions on international trade assumes especial urgency. In at least two respects post-War conditions have made it exceptionally important that such trade should have free scope: because of the large new international debt payments which could only be made finally in goods, and because of the unusual restrictions imposed on the migration of labour and to some extent of capital. That it has not had that scope is undoubtedly one cause of the world's economic and financial difficulties, although these difficulties have resulted in further restrictions on trade.

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Whilst in most countries the restrictions on foreign trade have been increased, however, the need for a reversal of this tendency seems to be recognized in all countries. This at any rate is a hopeful factor, and we may conclude this volume by considering the possibility of turning it to practical account.

One plan which readily suggests itself is that all countries should agree to a simultaneous reduction of tariffs under a general scheme of Tariff Disarmament. Attractive as this is as a general idea, however, serious difficulties are encountered immediately we endeavour to devise a scheme which would be generally acceptable. The reduction of all tariffs to a certain common level—assuming that this could be satisfactorily measured—would be not unreasonably opposed by the more protectionist countries on the ground that their industries have become adapted to their protectionist systems, and that the removal of a substantial part of this protection within any short period would mean an intolerable aggravation of existing difficulties. On the other hand, a scheme which provided for proportionate reductions from existing tariffs would be opposed as unfair by the low tariff countries, on the ground that it would stereotype what, from a protectionist angle, they would regard as their disadvantage. It

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was principally on this ground that the proposed Tariff Truce, precluding all increases in tariffs, was defeated.

In view of the small prospect of achieving success by way of a general agreement, it has been suggested that a beginning might be made by agreements between particular countries so constructed as to allow of extension to other countries, if and when they chose to become parties. This implies, of course, that the concessions made mutually between the original parties are not to be extended automatically under the most-favoured nation clause; and those who advocate this type of scheme criticize the strict maintenance of the most-favoured nation principle as an obstacle to what I have called earlier "conciliatory bargaining." I do not think that it can be disputed that the clause may have this effect; whether or not it is a bad effect depends on the exact character of the agreements to which it is an obstacle. It is not proposed, however, to abrogate treaty rights without the consent of the other parties. The further question arises, therefore, as to whether the terms on which admission to the arrangement is offered to "third party" countries are a fair compensation for the surrender of their most-favoured nation rights.

A proposal along these lines has been put

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forward by Sir Arthur Salter in his book *Recovery* (p. 190). The suggestion is that a number of states should agree not to increase tariffs against one another, nor against other states "unless the latter make such new increases in their tariffs as to change the whole situation"; and further to make progressive reductions in the duties imposed on one another's trade, these reductions being designed so as "to make their tariff levels more equal (the greatest reductions being therefore where tariffs are now highest)." Within the group of associated states the most-favoured nation principle should be applied without restriction and on the basis of a standard classification. It is contemplated that the group should be originally composed mainly of European states, but "the association should be and remain open on equal terms to all countries of all continents." Inspired apparently by this idea a Convention has actually been signed (July 18, 1932) between the Governments of Belgium, Holland and Luxemburg, which binds the parties not to increase their tariffs and provides for an immediate reduction (subject to certain exceptions) of 10 per cent of the existing duties on one another's trade, to be followed by annual reductions of similar amounts for four years. In this way the duties on their mutual trade will be reduced by stages

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to one-half, although certain minimum rates are provided. It is not intended to extend these reductions freely to other countries enjoying most-favoured nation rights, but any country may adhere to the convention on the same terms, or, without signing the Convention, it will receive the same concessions if it in fact observes the same conditions. It may be remarked that there is a difference between the Salter plan and the Belgian-Dutch Convention in respect to the mode of tariff reduction: whilst in the former they were to be proportionally greater in the case of the higher tariffs, in the latter they are to be strictly proportional to the duties as existing in the summer of 1932. (The text of the Convention was printed in a supplement to *L'Indépendance Belge* of August 6, 1932.)

As the proposed reductions are to be applied uniformly throughout the tariffs they would necessarily result in the abandonment of a large measure of protection; and if, as is contemplated, the countries associating are largely competitive, there need be no misgiving that the effect of the arrangement would be to distort trade rather than to free it. The points to be considered, therefore, are the readiness of the various countries to join some such association, and the attitude of

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those countries which are not prepared to join.

As the original parties to the July 'Convention themselves rank as comparatively low tariff countries, the terms on which they offer to share their mutual concessions with other countries must be considered generous. But it may be doubted whether the Convention will provide an acceptable basis for the reduction of duties in the trade between other countries. On the face of it, it would appear likely to be as unsatisfactory to other relatively low tariff countries as the proposed Tariff Truce. On the other hand, the Salter plan with its greater proportional reductions in the duties of the high tariff countries is likely to be unacceptable to the latter. In short, essentially the same difficulties are to be expected in endeavouring to get countries to adhere to a partial scheme as in trying to arrange a general one, and the latter procedure only offers advantages if there is a prospect that the countries which would not be prepared to participate in the reductions would be ready to acquiesce in discrimination against their products.

In presenting his proposal Sir Arthur Salter stresses the especially grave plight in which the European countries find themselves and the importance to the world as a whole of

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European recovery. He also suggests very reasonably that in view of the exceptions to the most-favoured nation clause which already exist, the extra-European countries would have no valid ground for objecting to the treatment of Europe as a whole as a "regional exception." It is to be hoped that these views will receive sympathetic consideration outside Europe. I find it difficult to see, however, how there can be combined in one scheme the idea of making special provision for Europe and the idea of inaugurating a movement which will eventually become general. I should expect difficulties to arise immediately some extra-European countries adhere to the plan whilst others remain outside.

One may contrast with these various proposals the approach to freer trade which economists have usually advocated in the past: the recognition by each country that it injures itself by restricting its own trade, and that accordingly in reducing its tariffs it is benefiting itself as much as making a concession to other countries. Disappointing as attempts to advance along these lines have been, it is still doubtful whether a better way of combating protectionism can be discovered. At the same time, however, there are features in the present situation which favour attempts to organize common action. During the last

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two years many of the restrictions which have been imposed on foreign trade have been designed, not so much to give protection to particular industries, as to protect the balance of payments—to prevent the depreciation of currencies which have left the gold standard or to enable currencies to remain at least nominally on the gold standard. Such restrictions do, of course, have a protective effect, but the vested interests to which they give rise are less deeply rooted than those of the export industries which suffer from the import restrictions of other countries. Accordingly there is more hope that restrictions of this type will yield to negotiations than ordinary protective tariffs. At the same time it is especially difficult for countries to remove restrictions of this sort without the assurance of similar action by others—unless the lead is taken by the few countries which have a creditor balance, or are in a relatively strong position by virtue of their gold holdings or the confidence in their currencies. It must be admitted that in practice it is often difficult to distinguish the motives underlying the imposition of duties, and that nothing can be accomplished without a genuine desire for freer trade all round. None the less, it appears that the method of common action is most likely to yield results if it is mainly directed

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towards removing these special restrictions, and leaves ordinary protection to be dealt with by the slower process of unilateral reductions and special concessions generalized by the most-favoured nation clause.

NOTES ON SOME ECONOMIC TERMS

THE theory of international trade being part of the general theory of economics, it is difficult to write on the subject without assuming some acquaintance with the conceptions and terms used by the economist. For those to whom these are unfamiliar, the following notes on a few of the terms used in the foregoing may be useful.

Elasticity of Demand. The economist thinks of the demand for a commodity at any time, not as a fixed quantity, but as a scale or series of quantities varying with the price or terms on which the commodity is obtainable; the assumption being that more will be demanded at a low price and less at a high price. "Elasticity of demand" refers to the relation between the change in the quantity demanded and the change in price or value per unit. If a given change in price would be accompanied by a relatively large change in the quantity demanded, the demand is said to be "elastic"; if the quantity demanded would be relatively little affected by the change in price, the demand is said to be "inelastic." The total value of the amount dealt in is obviously the product of the quantity dealt in and the value per unit, two factors which vary in opposite directions. If a change in price would leave the total value of the amount dealt in unchanged, because it would be precisely compensated by the change in the amount, the elasticity of demand is said to be "unity." If the total value moves in the same direction as the change in price—the change in amount having less influence—the elasticity of demand is said to be less than unity; if the total value moves in the opposite direction to the change in price—the change in amount having more influence—the elasticity of demand is said to be greater than unity. In this way more precision is given to the terms "inelastic" and "elastic" respectively.

NOTES ON SOME ECONOMIC TERMS

The Factors of Production. It has been the traditional practice to divide the requisites of production into three essential factors or agents—land, labour and capital. The term “land” is used to cover all the resources provided by nature, in their unimproved state; “labour” covers all forms of human effort or activity in the utilization of economic resources; “capital” means wealth, itself the result of production, which is designed to assist in further production and which has been made available by the decision to spare certain resources from production for current consumption. This three-fold division is obviously exhaustive, and is often sufficient for the purposes of a broad theory. It is equally clear, however, that there are in reality many perfectly distinct kinds of natural resources and as many different kinds of human activity, the economical allocation of which presents in each case a separate problem. There are also many different forms of capital-goods and capital-improvements, but in most of our problems we are concerned with the allocation of savings available for investment or embodiment in these diverse forms, and this new capital is homogeneous in units of purchasing-power or money.

It may be added that the adjective “real” has often been used above to distinguish the ultimate means and ends of economic activity from their expression in money. This usage is fairly familiar in the phrase ‘real wages,’ meaning what wages will purchase as opposed to their amount in money. It should not be difficult to apply the same idea in interpreting such an expression as “the real terms of exchange between two countries.”

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A study of Marshall's diagrammatical treatment of international demands and their interaction in Appendix J to *Money, Credit and Commerce* (Macmillan), and in *The Pure Theory of Foreign Trade* (L.S.E. Reprint) should help to clarify some of the points in Chapters III-IV.

2. For the theory of the foreign exchanges, and particularly the purchasing power parity theory, see: Cassel, *Money and Foreign Exchange after 1914* (Constable); Keynes, *Tract on Monetary Reform*, chapter 3, and *Treatise on Money*, vol. I, especially pp. 69-75 (both Macmillan); and Gregory, *The Gold Standard and its Future* (Methuen). The chapter in Mr. Keynes' *Tract* is also especially good on the subject of Forward Exchange. Amongst earlier writings Senior's *Lectures On the Transmission of the Precious Metals*, and *On the Cost of Obtaining Money* (L.S.E. Reprints) are particularly interesting. Professor Taussig's pupils have made a number of important historical studies of international monetary adjustments, of which the most notable is Professor Viner's *Canada's Balance of International Indebtedness, 1900-13* (Harvard).

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