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***International Trade and  
Commercial Policy***

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# ***International Trade and Commercial Policy***

. By . . .

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*New York and London .*

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**INTERNATIONAL TRADE AND COMMERCIAL POLICY**

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# *Contents*

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Preface	xi
I. INTRODUCTION	1
Basic Similarity of International and Domestic Trade—Distinctive Characteristics of International Trade—Importance of Foreign Trade to the United States—Technology and Protection	
II. EARLY TRADE AND TRADE POLICIES—MERCANTILISM	16
The Nature of Mercantilism—Mercantilist Policies and Doctrines—The Ebb of Mercantilism—Modern Mercantilism—Critique of Mercantilism	
III. FOREIGN EXCHANGE: THE MECHANISM OF INTERNATIONAL PAYMENT	36
Financing Foreign Shipments—Foreign Exchange Essentially an Offsetting of Foreign Debts and Credits—Types of Bills of Exchange—Alternative Methods of Financing Foreign Shipments—The Letter of Credit—Demand for and Supply of Bills of Exchange—The Balance of International Payments—Balance of Trade and Balance of Payments	
IV. FOREIGN EXCHANGE: RATES OF EXCHANGE	64
Determination of Exchange Rates—Rate Variations Under the Gold Standard—Rate Variations Under Inconvertible Paper—Arbitrage—Forward Foreign Exchange	
V. THE CASE FOR FREE TRADE: THE MODERN CLASSICAL THEORY OF INTERNATIONAL TRADE	84
The International Division of Labor—The Theory of Comparative Costs—Wages, Prices, and Competitive Ability	
VI. REFINEMENTS OF THE CLASSICAL THEORY	104
Domestic Goods—Domestic Wage Differences—Capital Charges—Increasing Costs—Decreasing	

	Costs—Many Commodities—Several Countries— Materials, Rents, Tariffs—Summary	
VII.	THE MUTUAL INTERDEPENDENCE THEORY	128
	Criticism of the Classical Theory—Ohlin's Mutual Interdependence Theory—Transportation Costs— Effects of Trade upon Factor Prices—The Gain from Trade—Scale of Production and the Social Conditions of Production—Summary—Note on Pro- fessor Haberler's Theory	
VIII.	ADJUSTMENT OF DISEQUILIBRIA IN THE BALANCE OF INTERNATIONAL PAYMENTS: GOLD STANDARD CONDI- TIONS	155
	The Nature of International Equilibrium—Sources of Disturbances of Equilibrium in the Balance of Payments—Mechanisms of Adjustment of Interna- tional Disequilibrium	
IX.	INTERNATIONAL-PAYMENTS EQUILIBRIUM UNDER IN- CONVERTIBLE PAPER CURRENCIES	185
	The Purchasing-Power Parity Theory—Weaknesses of the Purchasing-Power Parity Doctrine—The Equilibrium Rate of Exchange—The Adjustment of Disequilibria—Exchange Depreciation and Price Changes	
X.	TARIFFS: THEIR NATURE AND EFFECTS	215
	The Restrictive Nature of Modern Commercial Pol- icy—Nature and Types of Tariffs—Transit Duties —Import Duties—Export Duties	
XI.	THE CONTENT AND FORM OF TARIFF LAWS, BOUNTIES	241
	Tariffs—Bounties	
XII.	ARGUMENTS FOR PROTECTION	271
	Free Trade—Protection	
XIII.	ARGUMENTS FOR PROTECTION ( <i>Continued</i> )	300
	Why Tariffs Persist—The Tariff and American In- dustrial Development	
XIV.	METHODS OF MITIGATING THE TARIFF	332
	Exemption from and Reduction of Duties—Draw- backs—Improvement Trade (Temporary Admis-	

## Contents

ix

sion)—Bonded Warehouses—Transit and Trans-shipment—Free Ports and Free Zones	
XV. INDIRECT PROTECTIONISM. PROTECTIVE EXCISE TAXES	351
Indirect Protectionism—Protective Excise Taxes	
XVI. COMMERCIAL TREATIES. THE MOST-FAVORED-NATION CLAUSE	372
Commercial Treaties—National Treatment—Reciprocity—Most-Favored-Nation Treatment—Conclusion	
XVII. TARIFF BARGAINING	393
American Experience with Tariff Bargaining Before 1934—The Reciprocal Trade Agreements Program	
XVIII. IMPORT QUOTAS	426
The Growth of Protectionism—Import Quotas—Milling, Linked-Utilization, and Linked-Purchasing Regulations—Import Monopolies—Conclusion	
XIX. EXCHANGE CONTROL	457
The Nature of Exchange Control—Why Exchange Control Was Introduced—The Technique of Exchange Control—Blocked Accounts—Multiple-Rate Systems in South America—Some Effects of Exchange Control—Summary	
XX. CLEARING, COMPENSATION, AND PAYMENTS AGREEMENTS	480
Clearing Agreements—Compensation Agreements—Payments Agreements—Conclusion	
XXI. DUMPING	506
The Nature of Dumping—Kinds of Dumping; Motives for Dumping—Conditions Necessary for Dumping—Effects of Dumping on Prices in the Dumping Country—Consequences of Dumping to the Importing Country—Measures to Combat Dumping—Anti-Dumping Laws	
XXII. INTERNATIONAL COMBINATIONS	529
Types of International Combinations—Conditions Conducive to International Combination—The Goals of International Combination—Economic	

	Policies and Practices of Combinations—International Combinations and the Tariff—Political Aspects of Cartels—Conclusion—Food and Agricultural Organization	
XXIII.	MERCHANT MARINE POLICIES	572
	The Case for a National Merchant Marine—The Shipbuilding Industry—Techniques of State Support to the Maritime Industries—American Merchant Marine Policy—Conclusion—International Air Transport	
XXIV.	COLONIES	616
	What Are Colonies?—Location and Products of Colonies—Periods of Modern Colonial Development—Why Colonies Have Been Sought—Colonial Economic Policies—Do Colonies Pay?—Statistical Appendix	
XXV.	INTERNATIONAL INVESTMENT	649
	The Significance of International Investment—The International Lenders—The Nature of Capital Export—Incentives to Foreign Lending—Types of Foreign Loans and Investments—The State and Foreign Investment—Economic Effects of Capital Export—The International Bank for Reconstruction and Development	
XXVI.	INTERNATIONAL MONETARY RELATIONSHIPS	694
	The Gold Standard—Flexible Exchanges—Exchange Stabilization Funds—International Monetary Cooperation—The International Monetary Fund—Appendix: The Gold Exchange Standard	
XXVII.	THE FUTURE OF INTERNATIONAL TRADE	735
	Are the Foundations of International Trade Crumbling?—International Cooperation the Basis of a Sound World Economy—Transitional Problems—Permanent Foundations of a World Trading System—Key Position of the United States—International Trade and War—Note on the Purposes of the Proposed International Trade Organization	
	Index	763

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## *Preface*

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The havoc and devastation wrought by two world wars within the short span of a quarter of a century and the recent invention of such fiendishly effective instruments of annihilation as the rocket bomb and the atomic bomb have forced upon men the conviction that only the creation of a just and stable basis of international relationships can save mankind from ultimate self-destruction. The establishment of the United Nations has given the world a political framework within which matters of international discord may be dealt with peaceably around the conference table, rather than by resort to armed conflict. It is widely realized, however, that a world political organization cannot hope to succeed in its mission of maintaining world peace unless it rests solidly upon a foundation of social and economic justice and opportunity, unless each and every national group is left free to raise its living standards to the highest level compatible with national and world resources, without hindrance or restriction by other nations.

The present volume is devoted primarily to the study of the economic bases of international relations and the effects of international relations upon national incomes and national prosperity. But the political aspects of international relations are not ignored, for in the international sphere as in the domestic sphere political and economic forces are inextricably entwined. No pretense is made herein of blazing new trails in the field of international economics. The purpose of this book is, rather, to acquaint the student with the major issues of international economics and their political ramifications, to familiarize him with the tools of economic analysis which have been forged and improved over the past two centuries and more, and to instruct him in their use, particularly with reference to the commercial policies of nations.

In its preparation, the author has drawn generously from the contributions of classical and modern economists. Over the past quarter of a century several admirable treatises on international trade have been published; if the present work even approaches the high stand-

ards set by some of these earlier works, the author will feel that his efforts have been well repaid. If the publication of this book has any particular justification, it lies in the somewhat greater emphasis that it places upon private and governmental policies with respect to international trade, compared with some of the earlier general treatises. A serious effort is made to trace the economic, social, and political sources and effects of various policies, not merely to describe them.

The major emphasis in the present volume is upon commercial policy, i.e., governmental and private policies that concern a nation's economic relations with other nations. More than two-thirds of the book deals with this aspect of the subject. One cannot intelligently appraise the effects of specific commercial policies, however, without an acquaintance with the basic principles of international trade and foreign exchange and without an understanding of the processes by which disequilibria in international balances of payments are corrected. The first nine chapters of the book are therefore devoted to these fundamental topics. Familiarity with the principles expounded in these chapters is essential to an understanding of the later chapters.

*It is not the function of an economist qua economist to determine the goals of social and economic policy. His task is rather to point out the probable effects of specific social policies and to recommend policies which offer the greatest promise of attaining certain ends which society deems desirable. In these pages the traditional role of the economist is adhered to. At the same time, it is constantly kept in mind that the purpose of economic activity is the production of goods and services, that the primary task of an economic system is the allocation of scarce means to alternative uses, that mankind is ever striving to realize from its limited resources the maximum social product. Throughout this work, therefore, the probable effects of specific measures and situations upon the size of the social product and the probability that such measures may increase, or reduce, this product are carefully considered. In general, it is concluded that the maximum real income is to be realized by each and every participating nation by the unrestricted international exchange of goods and services. But the efficacy of specific measures for attaining other objectives is not overlooked.*

The present volume is designed primarily as a textbook for college and university courses in international trade. It is hoped, however, that the general reader may find it helpful in gaining a comprehension of the problems of this important, but difficult, field of economics and in acquiring a familiarity with the analytical tools that economists have devised to cope with these problems. When this book is used as a text in a college or university course, the instructor may use the sources referred to in the footnotes and the lists of suggested readings at the end of each chapter to expand the topics which deserve more emphasis than has been given them within these covers. Others may also find these references useful guides to additional reading in the various branches of the subject.

I wish to take this opportunity of expressing my gratitude to all those who have given me aid in preparing this volume and whose friendly criticisms and suggestions have contributed much to its improvement. In particular, I want to thank Professor Archie R. Bangs of Trinity College, who has read a large part of the manuscript and whose valuable criticisms and suggestions have done much to improve its quality, and Professor W. Harrison Carter, Jr., of the University of Connecticut, who has read the manuscript in its entirety, pointed out numerous errors which had escaped the author's attention, and offered much constructive advice. Finally, I desire to express my appreciation for permission to quote from volumes copyrighted by the following publishers, in some instances rather extensively: American Economic Association; The Brookings Institution; Council on Foreign Relations, Inc.; Duell, Sloan & Pearce, Inc.; Harvard University Press; International Labor Office; The League of Nations and The United Nations; Longmans, Green & Company, Inc.; The Macmillan Company; McGraw-Hill Book Company, Inc.; The University of North Carolina Press; W. W. Norton & Company, Inc.; Oxford University Press (The Clarendon Press); Princeton University Press; The Royal Institute of International Affairs; Yale University Press.

The author assumes, of course, full responsibility for the points of view expressed herein and for possible errors and shortcomings.

L.W.T.

*Hartford, Connecticut*  
*January 21, 1947*





***International Trade and  
Commercial Policy***

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## *Introduction*

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Trade is the foundation of modern economic activity. Because the physician is able to exchange his skill for beefsteak, potatoes, automobiles, shelter, dental services, golf balls, symphony concerts, and myriad other consumable goods, he is able to devote his entire time to the practice of medicine, as well as to the further development of his skill. Likewise, the wheat farmer, the automobile worker, the plumber, the textile worker, the movie actor, the teacher—all find it possible to enjoy a wide variety of consumers' goods even though each one produces no more than a single commodity or service, and many perform only one small operation in the production of their own special product. If it were not possible to exchange the product of his own labor for the products of his fellows, each and every one would have to abandon his special trade and set about producing everything which he aspires to consume, just as his forebears on the medieval manor or on the early frontier homestead did. A society built upon the division of labor is impossible without trade.

The benefits which flow from the division of labor are too familiar to warrant elaboration here. In brief, specialization enables a community to produce from a given quantity of productive resources a larger volume of goods which are wider in variety and better in quality than if each member of the community were compelled to be a jack-of-all-trades. Individuals with particular talents are enabled to work at those jobs in which their talents can be put to best use, while those less talented may, nevertheless, acquire adequate skill in particular lines. Furthermore, time is not lost in transferring from one job or operation to another.

But the advantages of trade are not confined to the division of

## 2 International Trade and Commercial Policy

labor among the members of a single community. Just as members of one community find it profitable to specialize, so do communities and regions. Florida, California, and Texas exchange their citrus fruit for Lynn and Brockton shoes, Detroit automobiles, Minnesota flour made from North Dakota wheat, Maine and Idaho potatoes, radios made in New Jersey, and dresses made in New York. The list could be extended almost indefinitely.

The advantages of the division of labor and trade do not end at national boundaries. Nations, as well as regions and individuals within a single nation, find it worth their while to specialize and to trade. The United States produces more wheat, tobacco, cotton, automobiles, typewriters, tractors, and gasoline than her people can consume in order that she may exchange these domestic surpluses for Persian rugs, Malayan rubber and tin, Chinese and Indian teas, Cuban sugar, French dyestuffs, Australian wool, and a host of products of which other nations produce quantities in excess of their domestic needs. Brazil is able through her exports of coffee to buy British textiles and German tools and machines. Guatemala's exports of bananas are her means of acquiring foodstuffs from the United States and manufactured goods from the industrial countries of the West.

The real significance of trade, however, is not that it is a device for the disposal of unwanted domestic surpluses. If there were no trade, there would be no surpluses! For without trade, individual regions and nations could not afford to specialize and produce surpluses. Those factors of production at present employed in turning out surpluses would have to be transferred to the production of goods now acquired from others through exchange. Trade, in short, is responsible for an organization of production entirely different from that which would exist without trade.

But international specialization, like all specialization, has one shortcoming: it increases the interdependence of peoples. Once the national productive machinery has been fashioned to produce surpluses for export, any interference with the disposal of a nation's exportable surpluses becomes a matter of grave concern to its industries and its people. The curtailment of foreign markets injures the southern cotton farmer, the Iowa hog raiser, the western fruit grower, and the manufacturer of American office machinery. Like-

wise, the inability to obtain the usual flow of materials from abroad may force a drastic contraction of production in dependent domestic industries. A recession in any domestic industry is felt in other industries, and may develop into a general business recession.

### BASIC SIMILARITY OF INTERNATIONAL AND DOMESTIC TRADE

International and domestic trade are fundamentally alike. International trade can be regarded as simply an extension of domestic trade, an extension which makes possible a more complete division of labor and a more effective use of world resources. National boundaries are more or less arbitrary. They are the creatures of historical fortune, and have not been set with the purpose of erecting efficient, self-sufficing economic units. Nations,<sup>1</sup> like individuals, differ in their productive equipment, both natural and acquired; they differ in their endowment with material resources and in climate and temperature; they differ in their rates and levels of development of production techniques, especially the techniques related to the chemical and mechanical arts; and they differ in the relative proportions of their factors of production—land, labor, and capital. These dissimilar aptitudes provide the same substantial basis for national specialization and international trade that divergent individual aptitudes do for individual specialization and domestic trade.

Up until the first World War foreign trade, like domestic trade, was carried on between individuals or firms. Individuals, to the extent that they are rational and well informed, will buy where they can buy most cheaply and will sell where they can realize the greatest profit. International trade has thus tended to arise when individuals have found that they can buy more cheaply in foreign countries than in their own country, and can sell in foreign markets to better advantage than in the domestic market. The custom of speaking in such terms as "the United States buys from Brazil" and "India sells to the United States" has tended to obscure the basic fact that the trade which crossed national boundaries has been, like domestic trade, trade between individuals and firms. Since 1939, however, there has been a tendency in most countries to concentrate foreign trading in the hands of official agencies. The concentration of

<sup>1</sup> And also regions within a nation.

## **4 International Trade and Commercial Policy**

foreign trading in the hands of governments was primarily the result of the war and preparation for war, although the totalitarian countries had long before 1939 placed foreign trade under strict government control. When foreign trade is directed by government, its course is not necessarily shaped by commercial considerations; foreign trade may be forged into a powerful instrument for the attainment of political and military ends. It is at present impossible to predict how far foreign trade may be restored to the realm of free private enterprise in the future. It is to be expected that in many countries government controls which have been imposed for war purposes will be gradually relaxed. But Soviet Russia and her satellite countries may be expected to maintain government direction of all foreign trade, while countries which have nationalized important segments of their economies, e.g., Great Britain and France, may find it inexpedient to abandon completely government control over foreign trade.

### **DISTINCTIVE CHARACTERISTICS OF INTERNATIONAL TRADE**

Since international trade and domestic trade are essentially similar; since, moreover, the general body of economic principles affords an effective set of tools for the study and analysis of internal trade, the question may fairly be asked why there is a need for the study of international trade apart from that of internal trade. Despite the identity of the two in their basic features, the political division of the world into national states creates for international trade special problems which do not arise for purely domestic trade.

First, in practically all countries governments seek to regulate international trade in the national interest. Trade crossing the frontier is subject to special taxes and is limited by quotas; the movement of certain goods may even be prohibited. Government control of the means of making payment abroad or the requirement of government license to enter into foreign trade may make official approval a prerequisite of any dealings with individuals in foreign states. Even the movement of persons and capital across the border is the subject of regulation. One reason for this special governmental attention to foreign trade is that this trade has proved a convenient source of state revenue. Another is that foreign traders are in

a position to involve the government with foreign governments. But the most important reason is that the people believe that foreign trade, unlike trade within the national boundaries, is not beneficial and that imports are positively harmful. Popular thinking on international economic matters has progressed little beyond the mercantilism of the seventeenth and eighteenth centuries.

Second, nations possess not only independent currency systems but also independent institutions of banking and public finance. The existence of separate currency systems and banking institutions makes the task of remitting payments from one country to another different in essential respects from that of effecting payment within a country, where there is a uniform currency and only one banking system. Within a country, all prices are quoted in a single unit of account, and there is a single currency by which all debts quoted in this unit are settled. Facilities for making payment between different parts of the country are provided by the banking system, commonly without charge. In international transactions, on the other hand, at least one of the parties to every transaction must convert his domestic currency into a foreign currency, and the rate at which different currencies are converted thus becomes an important item in the calculations of businessmen. Variations in these foreign exchange rates may exert a profound influence upon the currents of trade and the level of productive activity within the nations concerned.

The existence of independent national financial institutions is important for international trade in yet another respect. Economic disturbances originating in one country tend to spread to other countries, and these institutions play a vital role in the transmission of such disturbances. The examination of the mechanism by which these disturbances are transmitted and of the effects they produce is one of the main tasks for the theory of international trade and finance. Furthermore, national fiscal and monetary policies profoundly affect domestic economic activity, and thus indirectly influence foreign trade and economic activity in foreign countries.

Third, labor and capital move from one country to another with much less facility than from one occupation to another, within limits, or from one place to another within a single country. The result of this relative immobility of labor and capital between coun-



## 6 International Trade and Commercial Policy

tries is that the proportions of labor, capital, and natural resources in different countries vary markedly, some countries having a relative abundance of labor, others of capital, and still others of certain natural resources. Because the price of any factor tends, in general, to vary inversely with its scarcity relative to the other factors of production in that region, the relative prices of the various factors of production may thus differ considerably from country to country.<sup>2</sup> And because the price of an article tends to equal the sum of the products of the quantities of the factors used to produce it multiplied by their respective prices, the comparative values of goods produced in different countries will differ. It is upon these differences in the comparative values of goods in different countries that the international exchange of goods rests. If the ratios of the prices of the various goods were the same in all countries, in the absence of international trade, no permanent system of international exchange could be established. These varying price ratios between countries rest, in turn, upon unequal factor equipment.

The basic assumptions of the classical theory of international trade were that labor and capital are highly mobile within a country but are immobile between countries. Because of this internal mobility and international immobility of labor and capital, wage and interest rates tend to an equality within a given country but differ sharply from country to country. These assumptions of the classicists have been soundly criticized. It has been justly pointed out that mobility is far from perfect within countries and that differences in wages for the same general grades of labor do exist within a single country; that if the assumption of international immobility were true, the only inhabitants of the United States today would be Indians—and anthropologists tell us that even the Indians were immigrants. The fact is, of course, that large international movements of both labor and capital have taken place. More than thirty-eight million persons have immigrated to the United States alone since its founding, and in 1929 the foreign investments of Great Britain and the United States alone aggregated thirty-five billion dollars.

Yet, despite the absence of complete labor mobility within a nation and the large-scale movements of people from nation to nation, wages in different countries do not approach so closely a

<sup>2</sup> This point is elaborated in Ch. VII.

common level as wages in different localities within the confines of a single nation do. The relative narrowness of wage differences in different regions within a country is portrayed by Table 1, which presents averages of money wages in six cities in the United States

TABLE 1. Average Money Wages in Six Cities in the United States for the Year 1925

Portland, Oregon	\$1332
Springfield, Massachusetts	1310
Cincinnati, Ohio	1271
Minneapolis, Minnesota	1270
Dallas, Texas	1180
Atlanta, Georgia	969

Source: *Statistical Abstract of the United States, 1930*, p. 826

in 1925. The highest average, Portland, is only 37 per cent higher than that of the lowest, Atlanta, and the differences in real wages would probably be less.

In contrast to the narrowness of wage differences within a country, Table 2 reveals the very wide variations which exist in real wages among large towns in different countries.

TABLE 2. Index Numbers of the Relative Levels of Real Wages in Large Towns in Different Countries in July, 1930

Country	Number of Towns	Real Wages
(Base: Great Britain = 100)		
United States	10	190
Canada	6	155
Denmark	1	113
Sweden	3	109
Great Britain	7	100
Irish Free State	3	98
Netherlands	4	82
Germany	6	78
Poland	4	61
Austria	3	48
Yugoslavia	4	45
Spain	4	40
Italy	6	39

Source: *International Labor Review*, October, 1930. Quoted by H. B. Killough, *International Trade*, p. 18.

While the data have certain shortcomings which impair their strict accuracy, such as smallness of the sample, they nevertheless indicate

## 8 International Trade and Commercial Policy

definitely that in some countries labor is scarce and relatively expensive, while in others it is abundant and cheap. International migrations have obviously not been on a scale sufficiently great to eliminate these differences.

The unwillingness to become a foreigner in a strange land, the barrier of language and customs, and the lack of funds to make a costly move to a distant country are all barriers to emigration. But of greater importance than these natural barriers to free movements of populations are the artificial barriers which nations have erected, particularly in the period subsequent to the first World War. Natives of the densely populated areas of Asia have been practically prohibited from immigrating to English-speaking lands. Since the depression of the 1930's, further restrictions have been imposed which have reduced all immigration to a mere trickle, regardless of national origin.

Somewhat similar obstacles impede international movements of capital, though to a smaller degree.<sup>3</sup> But just as high wages have attracted population to foreign lands, so have high rates of interest attracted capital. At the same rate of interest for a given type of investment, the owner of loanable funds would naturally prefer to invest at home, because the uncertainties are fewer. Only a higher rate of interest will induce the lender to send his funds abroad instead of investing them at home. Because capital will in normal times flow abroad only if attracted by higher interest rates, however, the interest differential against borrowing countries tends to be perpetuated. This natural differential is, furthermore, frequently widened as a result of government restrictions upon international capital movements.

The relative immobility of labor and capital movements which has been shown to exist between nations is also present, though to a lesser degree, between different regions of a single nation. Persons and capital move more freely within New England, for instance, than they do from New England to Texas, or from Oregon to Alabama. Because of this basic similarity between international and interregional trade, Professor Ohlin begins his study of international trade with an analysis of interregional trade and makes the analysis

<sup>3</sup> Capital, unlike labor, may migrate without the owner of the capital migrating with it.

of international trade a mere extension of the interregional analysis.<sup>4</sup> These differences between interregional and international immobility of capital and labor are clearly differences of degree rather than of kind. Nevertheless, both the volume and the permanence of international trade rest more largely upon wage and capital differences than is the case in interregional, domestic trade.

Fourth, the disparities in the laws, tastes, and customs of nations make international trading a more complicated business than domestic trading. Although the domestic trader may be subject to many local laws and regulations, the legislative acts of any nation rest upon a common foundation of legal philosophy and legal codes, and the acts of the national parliament apply, of course, to the entire nation. The basic legal codes and philosophies as well as national legislation are apt to be quite different, however, in other countries. The standardized sales messages of national radio hook-ups and national magazine circulation, together with easy and cheap travel and communication, also tend to standardize habits of consumption throughout a nation and to maximize the advantages of large-scale production. Goods destined for export to foreign countries, on the other hand, must frequently be specially designed to conform to the national tastes and customs of the country of destination. A large concern supplying a particular class of goods for sale in several different countries may consequently be unable to realize the advantages of mass sales and mass production to the same degree as one producing the same class of goods in the same volume for a single, large national market. Moreover, the American businessman who is accustomed to having his customers discount their bills within ten days or make a net settlement of their accounts within thirty days may find it difficult to understand why he should extend credit to a prospective customer in South America for nine months or a year, terms which may be customary in the latter's country.

#### IMPORTANCE OF FOREIGN TRADE TO THE UNITED STATES

It would never occur to an Englishman to question the importance of foreign trade to his welfare. He fully appreciates that the only way

<sup>4</sup> Bertil Ohlin, *Interregional and International Trade*, Harvard University Press, 1935. Professor Ohlin's thesis is summarized in Ch. VII.

## 10 International Trade and Commercial Policy

by which he and his forty-odd million countrymen can expect to survive on an island large enough to produce only a fraction of their required food and raw materials is by producing coal, ships, hardware, machinery, and other goods and services which may be exchanged with other countries for necessary foodstuffs and materials. From two-thirds to three-quarters of the food consumed by the inhabitants of the United Kingdom are imported. There are many Americans, however, who believe that foreign trade is so unimportant to the United States that we can raise our tariffs to prohibitive heights and strangle our foreign commerce without suffering any unpleasant consequences, in fact to our benefit.

When we compare the amount of our exports with that of our total production, or the amount of our imports with our total consumption, we find that our foreign trade is, after all, not impressively large. In the years prior to the Great Depression our exports averaged only about 10 per cent of our total production of movable goods,<sup>5</sup> or about four billion dollars in value. But like all averages, this one tends to obscure the importance which foreign trade bears to many of our basic industries and to agriculture. It has been estimated that over two million American workers, who with their families constitute over 10 per cent of the American population, are dependent for their livelihood upon export sales. In 1930, a year which may be taken as typical of the years before the depression, we exported 50 per cent of our production of motorcycles and turpentine, 40 per cent of our typewriters, 34 per cent of our copper and kerosene, 29 per cent of our printing machinery and lubricating oil, 28 per cent of our sewing machines, 23 per cent of our agricultural machinery, 21 per cent of our locomotives, 17 per cent of our cash registers, 15 per cent of our gasoline, and slightly less than 10 per cent of our automobiles. During the five-year period 1926-1930, we exported of our annual production of agricultural products 59 per cent of the cotton, 34 per cent of the tobacco, 54 per cent of the raisins, 50 per cent of the prunes, 31 per cent of the lard, 30 per cent of the rye, 20 per cent of the apples, 23 per cent of the rice, and

<sup>5</sup> The percentage of our exports to our total production would, of course, be much less. Since building construction and the great mass of our services could not possibly be exported, the percentage used in the text is deemed the more significant for our purposes.

18.5 per cent of the wheat. It is clear that for the prosperity of these segments of the American economy foreign markets are vital. For many industries a variation of as little as 10 per cent in output can mean the difference between operating at a profit and operating at a loss. It can be readily understood, furthermore, how a loss of export markets for many of these products would have a disastrous effect upon the national economy and might easily turn prosperity into depression.

The stoppage of our foreign trade would also force unpleasant alterations in our consumption. The attack on Pearl Harbor suddenly brought this fact home to us despite the continuance of much of our import trade. We import all our coffee, tea, and cocoa, much of our cane sugar, and practically all of our bananas. All, or large percentages, of the following basic materials consumed by us are imported from foreign lands: silk, crude rubber, fibers such as manila hemp, sisal, and jute, alloy metals such as tin, nickel, tungsten, and manganese, industrial and edible oils like olive, palm, coconut, whale, and tung, and large quantities of various other products, including newsprint paper, hides, wool, shellac, asbestos, bristles, chemicals, platinum, and lead. Any interruption of our foreign commerce would thus not only badly disrupt our economic activity but would also lower our living standards. A person who has lived through the period during which we have had to ration, or have suffered severe shortages of, rubber, tea, coffee, cocoa, wool, shoes, sugar, edible oils, and manila hemp, will readily see the point. Many of these commodities could under no conditions be produced in this country. To produce others which might conceivably be produced here would involve such high costs of production as markedly to lower our living standards.

### TECHNOLOGY AND PROTECTION

Science, invention, and engineering during the past century have combined to increase enormously the volume of international trade and to widen greatly its range. One of the most far-reaching accomplishments of technology has been cheapened transportation. The slow and relatively small sailing vessel of 1800 was supplanted by large and much faster steel ships propelled by steam, oil, or electricity; the pack horse, stagecoach, and horse-drawn wagon

## 12 International Trade and Commercial Policy

have given way to the modern locomotive, capable of hauling 100-car trains fully loaded at speeds unheard of a century ago, and to the highly flexible motor truck; the commercial possibilities of the airplane are just beginning to be conceived. All have combined to bring places formerly far distant from each other to within a few days, or at most weeks, of each other and to reduce unit costs of transportation to a small fraction of their former level.

Purchasers incline to buy in the foreign market when goods can be obtained more cheaply there than at home. But it is not sufficient that the price in the foreign market be lower than in the home market. The foreign price *plus the cost of transportation* must be lower. Many goods which can be produced more cheaply abroad are not imported because the addition of the transportation costs to the foreign price would exceed the domestic cost of production. Any cheapening of transportation costs will therefore widen the variety of goods which can be bought *and imported* more cheaply than they can be produced at home. In short, lower transportation costs nurture a more complete division of labor. Also, speedier transportation and refrigeration have made it feasible to transport over great distances perishable goods which earlier had to be consumed close to the point of production.<sup>6</sup>

Speedier and cheaper transportation, however, is not the only means by which technological advance has widened the range of international trade. New production techniques have greatly increased the advantages of mass production, and consequently of wide markets, particularly for the more specialized types of capital goods. The most important factor in the low price of American automobiles, for example, has been the large domestic market for them. This large domestic market has enabled the American industry to incorporate in its production all the available cost-reducing techniques, techniques which the same industry would have found it uneconomic to use had the market been considerably smaller. But even a market as vast as the American domestic market may not be large enough to take advantage of specialized machinery and mass production techniques in producing certain commodities, such as

<sup>6</sup> For a more detailed account of the reduction in travel time and changes in transport costs over the past century see Eugene Staley, *World Economy in Transition* (New York, 1939), Ch. 1.

electric locomotives, cargo ships, and large power-station generators. Only by manufacturing for a *world* market can production units for such goods attain the optimum size decreed by the contemporary stage of technology.

Technological developments have increased economic interdependence in yet another way. The new methods of production and the new demands resulting from new ways of living have resulted in an enormous increase, both in volume and variety, in the demand for raw materials. Since no country possesses sources of all these needed materials, since many countries possess very few, and since many of the materials are found in relatively few areas, they are to be obtained only by importation. Our own steel industry is dependent upon Canadian nickel, chromium from Rhodesia, South Africa, Turkey, or the Soviet Union, manganese from the Soviet Union, India, and Brazil, and tungsten from China; our canning industry upon tin from Malaya, the East Indies, and Bolivia; our rubber industry (at least up to the second World War) upon raw rubber from Malaya and the East Indies; our paint industry upon tung oil from China; and our tanning industry upon quebracho extract from South America—to mention only a few of our most basic needs.<sup>7</sup>

While science, invention, and engineering have combined to widen the area of economic contact and enlarge the movement of goods and capital across national boundaries, political forces have been indefatigably at work to restrict the expansion of world trade by means of tariffs, prohibitions, currency controls, quotas, and all the other instruments of trade restrictionism. Since 1880 the march of restrictionism has continued almost without interruption, and since World War I trade barriers have grown like a snowball rolling downhill. Thus technological and economic forces, on the one hand, and political forces, on the other, have been working at cross purposes during the past two-thirds of a century.

Granted the present unequal distribution of productive resources among nations, the limited supplies of the factors of production available to mankind can be employed most effectively to satisfy

<sup>7</sup> But science has also narrowed, to some extent, the range of international trade through the invention of substitute products. The development of synthetic rubber, nitrates, and camphor, for example, has lessened the dependence of many nations upon exports of Malayan rubber, Chilean sodium nitrate, and Japanese natural camphor.



## 14 International Trade and Commercial Policy

human wants by permitting the unrestricted development of the international division of labor and the free flow of goods between nations.<sup>8</sup> To the extent that the international flow of goods is impeded and the international division of labor curbed, humanity fails to reap the optimum output from its productive resources. But, despite the world-wide struggle for higher living standards, restrictionism rather than liberalism has continued to dominate the commercial policies of nations. Several factors have been responsible for this.

For one thing, the mercantilist doctrine that exports are good but imports harmful is still deeply rooted in popular thought. An excess of exports over imports is even today widely considered to be highly beneficial to a country. Many private and influential groups, furthermore, find that their own selfish interests are best served if imports which would compete in the domestic market with their products are kept out. The trend toward the industrialization of raw-material-producing countries has also tended to accentuate this demand for the protection of special interests.

Two factors have dominated commercial policy in the past two decades, namely, the fear of war and the quest for economic security. The very decision to industrialize is usually based upon one or both of these two considerations. In a world in which war is an ever present threat, the first consideration of every nation will be self-defense and self-sufficiency. No great power dare risk being cut off from some vital war material by an enemy if it can possibly produce that material within its own borders, whatever the cost of domestic manufacture. Synthetic fuel oils, synthetic rubber, and atabrine are creatures of the quest for self-sufficiency.

As long as nations are plagued by recurrent depressions and widespread unemployment, political pressures will compel governments to adopt policies designed to regain and stabilize full employment. The breaking-up of the world market into a series of protected national markets after the first World War did not, to be sure, ensure full employment. Economic nationalism tended rather to aggravate economic maladjustments. The belief is deeply rooted, nevertheless, that the success of domestic experiments in economic management must not be imperiled by external forces. If a rise in the

<sup>8</sup> This point is developed at length in Chs. V-VII.

domestic price level is deemed prerequisite to fuller domestic employment, the anticipated rise in employment must not be jeopardized by a flood of imports from countries whose prices have not advanced. If an easy money market is considered essential to increased domestic investment, easy money rates and new domestic investment must not be compromised by a flight of capital to regions of more lucrative yields. Tariffs and exchange control can provide the desired protection. Raw-material-producing countries seek to raise the living standards of their peoples and to avoid the deflationary shocks of world-wide depression through diversification and industrialization. But new industries in backward countries can hope to survive only if they are protected from the competition of firmly established foreign industries. International trade will not remain untrammelled in a world threatened by periodic wars and economic breakdowns.

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## *Early Trade and Trade Policies— Mercantilism*

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Mercantilism is an especially appropriate subject with which to begin a treatise on international trade. For one thing, the mercantilist writers of the sixteenth, seventeenth, and early eighteenth centuries were the first to attempt the formulation of a theory of international commerce. Whereas earlier writers, e.g., Plato, Aristotle, and Thomas Aquinas, had given some attention to economic principles of a sort, no comprehensive treatment of international trade had been essayed. In fact, little heed was given to trade of any sort by writers in ancient and medieval times, largely because commerce and merchants were held in low esteem. Politics, war, philosophy, and agriculture were considered pursuits worthy of the highest social classes, but trade was an occupation fit only for slaves or Jews. Although mercantilist doctrines have long ago fallen into disrepute among economists, many of them still command support among the masses.

In the second place, mercantilism represents the beginning of national regulation of international commerce in the modern period. Prior to the sixteenth century, national commercial policies can hardly be said to have existed, although there were state monopolies of trade in ancient Egypt and ancient Persia. The Mediterranean was the seat of a thriving commerce during ancient times, conducted chiefly by the Phoenicians and the Greeks, but the regulation of commerce during the era of Greek ascendancy was in the hands of the city states; no Greek nation existed. Roman commercial policy was a passive one, for the Romans regarded the trader with disdain.

The result was that Roman commerce was carried on largely by foreigners, especially the Greeks.

Following the disintegration of the Roman Empire, a thriving foreign commerce continued in the East, centered at Constantinople and Alexandria. In western Europe, however, centralized authority all but disappeared, leaving a multitude of small, virtually self-sufficient, agricultural communities. What little commerce remained took place chiefly at periodic fairs, to which the products of distant lands were brought by Greek, Jewish, Arab, and Norse traders. A revival of foreign commerce in the West had set in by the thirteenth century, conducted by the Italian city states and the Hanseatic cities of northern Germany. The Italian and Hanseatic fleets brought the products of the East and the Baltic to England and the Low Countries and there exchanged them for the products of the latter countries. But the control of this trade rested with the independent towns and provincial lords; the dominant political and economic unit of the modern era, the nation, had not yet emerged.

The slow emergence of nation states in western Europe from the fifteenth century on saw a shift in the control of trade from the towns and the feudal lords to the national states. This shift in the control of trade involved also a change in the objectives of control. Control of trade by feudal lords had aimed at lining the pockets of the controllers, control by the town authorities and guilds at protecting the standard of living of the local craftsmen and merchants from the evils of competition among their own members and from the encroachments of new competitors, both from within the community and without. As economic control passed from the lords and local units to the national monarchs and legislatures, however, it was turned to a quite different end—the building-up of the wealth, economic power, and political power of the state. Wealth and economic power were indispensable to the state that sought a dominant place in the circle of European nations and world empire.

### THE NATURE OF MERCANTILISM

“Mercantilism” is the term used to describe this system of state regulation of economic activity for the attainment of national wealth and political power. It comprised both the policies which guided the nations of western Europe, especially England, France, Holland,

## 18 International Trade and Commercial Policy

and Spain, during the sixteenth, seventeenth, and early eighteenth centuries, and the body of economic doctrines associated therewith. To refer to it as a "system" is, however, misleading in that the term suggests a unified body of doctrine preplanned and steadfastly pursued by statesmen for the attainment of some definite objective.

"If we look from the stratosphere at the mass of decrees spread over two or three centuries, [it is true that] certain general common features may be seen; but if we descend and examine each item in detail, we often find that action came from some desperate financial strait, some desire to strike or return a blow, some struggle with a war or post-war problem, some concession to a lobby, some sale of a privilege, or some imitation of another country. The one common feature was the exercise of state power over every side of economic life."<sup>1</sup>

Although the dominant objective of mercantilist policy was the building-up of national power, wealth, and prestige, it must be kept in mind that it was the growth of trade and the resultant breakdown of the manorial economy which underlay the decline of the feudal political structure and the rise of the national state. This expansion of trade gave birth to powerful commercial groups which worked untiringly for the development of a strong central government; the latter could be invaluable in promoting the interests of these economic classes. While rulers sought economic power for the furtherance of political ends, classes, groups, and individuals resorted to political maneuvering to attain economic objectives. Many mercantilist policies originated with monarchs and ministers; many more originated in trade circles, were urged upon the state by interested groups, and were then prescribed by the rulers. "The mercantilist state was thus servant as well as master."<sup>2</sup>

### MERCANTILIST POLICIES AND DOCTRINES

Mercantilist policies were centered around two principal ideas: the preeminence assigned to the precious metals, gold and silver, and the urgent desirability of establishing an excess of exports over imports. The second is really a corollary of the first. For if a nation must build up its stores of the precious metals to become great, it

<sup>1</sup> H. Heaton, *Economic History of Europe*, Harper & Brothers, 1936, p. 384.

<sup>2</sup> *Ibid.*, p. 388.

## Early Trade and Trade Policies—Mercantilism 19

can acquire the precious metals from only two sources: from its own mines, or by importation. If it possesses no mines, and few European nations of the seventeenth century were so fortunately endowed, then it can acquire specie only through importation. And specie will flow into a nation only when the value of its exports exceeds the value of its imports, and only to the extent of this excess. Few were the policies of mercantilist states, therefore, which were not designed to establish, directly or indirectly, this excess of exports.

*The Precious Metals as Wealth.* Adam Smith attributed this mercantilist predilection for gold and silver to the popularity of the notion that "wealth consists in money, or gold and silver," and he began his celebrated critique of mercantilism by attacking this idea. Mercantilist literature affords considerable support of Smith's view.

The general measures of the trade of Europe at present are gold and silver, which, though they are sometimes commodities, yet are the ultimate objects of trade; and the more or less of these metals a nation retains, it is denominated rich or poor. . . . Therefore, if the exports of Britain exceed its imports, foreigners must pay us the balance in treasure, and the nation grow rich. But if the imports of Britain exceed its exports, we must pay foreigners the balance in treasure, and the nation grow poor.<sup>3</sup>

. . . to take the right way of judging of the increase or decrease of the riches of the nation by the trade we drive with foreigners, is to examine whether we receive money from them, or send them ours; . . .<sup>4</sup>

. . . gold and silver is the only or most useful treasure of a nation . . . nothing but bullion imported can make amends for bullion exported.<sup>5</sup>

If the native commodities exported do weigh down and exceed in value the foreign commodities imported, it is a rule that never fails, that then the Kingdom grows rich, and prospers in estate and stock; because the over-plus thereof must needs come in, in treasure.<sup>6</sup>

These quotations, which it would be easy to multiply, sustain Smith's view that the mercantilists valued all goods other than gold

<sup>3</sup> Matthew Decker, *An Essay on the Causes of the Decline of the Foreign Trade* (1744), 1756, pp. 1-2. Cited by J. Viner, *Studies in the Theory of International Trade*, pp. 18-19.

<sup>4</sup> Joshua Gee, *The Trade and Navigation of Great Britain Considered* (1729), 1767 ed., p. 205. Cited by Viner, *op. cit.*, p. 18.

<sup>5</sup> John Pollexfen, *England and East-India Inconsistent in Their Manufactures*, 1697, pp. 18-19. Cited by Viner, *op. cit.*, p. 17.

<sup>6</sup> E. Misselden, *The Circle of Commerce* (1664), p. 7. Cited by Viner, *op. cit.*, p. 17.

## 20 International Trade and Commercial Policy

and silver only to the extent that they served as a means of acquiring the precious metals. But Smith exaggerated. Some mercantilists were never guilty of the fallacy of identifying money and wealth, and few writers of preeminence relied solely on such identification in arguing for the indefinite accumulation of specie. It may be truthfully said, however, that mercantilists as a group regarded gold and silver as by far the most desirable form of wealth.

The mercantilist predilection for the precious metals is explainable on several grounds. One of these is the gradual increase in interregional trade. Mention has already been made of the rapid expansion of western Europe's trade with other regions after the thirteenth century. The agricultural village community of the Middle Ages had been virtually self-sufficient, and what local trade there was had been largely on a barter basis. But non-local trade, particularly before the widespread development of banking, credit instruments, and clearing houses, required a medium of exchange; and as interregional trade expanded, more money was needed.

Some of the mercantilist writers demanded more money because they believed that money was scarce. It is true that from the early sixteenth century to the late eighteenth century commodity prices in England and other European countries were most of the time rising, although there were periods within this era when they moved downward. Rising prices were, to most writers, an evil which they did not associate with an increasing supply of money; rising prices created, rather, a need for more money, if trade was to be carried on efficiently and the poor were to be able to buy the necessities of life.

Another reason for the emphasis upon an abundant supply of the precious metals grew out of the transition from government by feudal lords to government by the modern state. Under the feudal economy, feudal lords were able to obtain the necessities of life from their vassals in the form of feudal obligations; the serfs produced goods for the lords on the lords' demesnes and they contributed goods of their own to the lords as feudal dues. Little money was required for maintaining armies, courts, and legislative bodies, for the feudal rights and duties of vassals included fighting, holding court, and attending council meetings. With the gradual commuta-

tion of feudal obligations into money payments, however, the lords and suzerains could no longer rely upon customary labor and services, but were compelled to use money to hire laborers, soldiers, and sailors, to buy military and naval equipment, and to maintain courts and administrative agencies. These mercenary armies and civil servants, incidentally, enabled the kings to become independent of their vassals. International wars, ambitious schemes of exploration and conquest, the expanding trade of the towns, and the growing desire for the luxury goods of the East by monarchs, feudal lords, and merchant princes increased the demand for money.

A further explanation of the importance ascribed to the precious metals was their potential value as a state treasure for use in an emergency, a not unusual view in a period before public borrowing could be relied upon as a dependable source of funds or before taxation had become a regular and flexible source of revenue. This view has its modern survivals. As late as 1870 the German government chose to store away in the war chest at the fortress of Spandau as a military reserve 120 million gold marks, part of the indemnity paid by the government of France at the conclusion of the Franco-Prussian war.<sup>7</sup>

The common doctrines of the day which exalted frugality and thrift and disparaged consumption also tended to elevate gold and silver in the esteem of the mercantilists. Not only the Puritans but the landed gentry, too, regarded frugality and thrift as virtues, at least for the middle and lower classes, since extravagance and ostentatious consumption were held to be the exclusive privilege of the landed aristocracy. Because saving was viewed as the piling-up of valuable goods rather than the means to investment, the goods to be stored had to be durable, preferably of great value in small bulk, and not liable to loss of value through physical deterioration or style change. Gold and silver admirably met these criteria. But if an individual becomes rich by selling more than he buys, and thus builds up an accumulation of money, will not the same result follow for a nation? Finally, many of the mercantilists wanted more money because they regarded it as an active stimulus to trade as it circulates from hand to hand, a view rather in conflict with the pre-

<sup>7</sup> Cf. Viner, *op. cit.*, pp. 22-25.



## 22 International Trade and Commercial Policy

ceding one but not at all unfamiliar to students of modern economic policy, with its currency devaluation, extended monetization of silver, deficit financing by commercial banks, and advocacy of the printing of inconvertible paper money.

*How to Acquire Gold and Silver.* The acquisition of gold and silver was easy for Portugal and Spain because the voyages of discovery of da Gama and Columbus enabled them to plunder the treasures of the natives of India and the New World and later to develop the mines of Mexico, Peru, and Brazil. But for those nations which did not directly control the sources of bullion, the accumulation of treasure could be accomplished only by preying upon the Portuguese and Spanish ships transporting bullion from the colonies to the home country, or by trade. Fortunately, the relative backwardness and imbalance of the industrial development of the latter two countries made it possible for England, France, and the Low Countries, more advanced industrially, to share generously in the newly discovered riches of Portugal and Spain. The mass of government regulations to which trade and industry were gradually subjected had as their main purpose the inducement of an inflow of the precious metals and the retention of these metals once they were procured.

The earlier period of mercantilism, sometimes termed the period of "bullionism" in contrast to the later period of "mercantilism,"<sup>8</sup> was characterized (1) by a particular concern that a country's stock of bullion be not reduced, (2) by the insistence upon each individual's having a favorable balance of transactions in his dealings with foreigners, and (3) by the close regulation of the transactions of individuals in the exchange market and in coin and bullion. Restrictions were placed upon the exportation of specie. In England the office of the Royal Exchanger was established with a monopoly over exchange transactions. The English Statutes of Employment required that foreign merchants pay for English commodities in coin or bullion, at least in part, and that the proceeds from the sale

<sup>8</sup> Viner has warned against the danger of attempting to draw any sharp dividing line in time between these two periods. The "mercantilist" doctrine of the balance-of-trade is found in the literature of the early period, while "bullionist" regulations are found in the later period. *Ibid.*, pp. 3-5.

of their goods in England be invested in English goods. The English Merchants of the Staple, who sold English raw wool on the Continent, were required to bring home in specie a part of the receipts from their sales abroad.

The Balance of Trade. The hindrances to trade which the application of these principles created led to their modification. It was pointed out that it was not the *individual* balance which was important but the *national* balance. If in the complex of commercial transactions the total value of the goods exported by a nation exceeded the total value of those imported, the balance due the nation must be paid in specie. Such a balance was called a "favorable balance of trade," while the situation in which the value of a nation's imports exceeded that of her exports was designated an "unfavorable balance of trade." The latter would, of course, lead to a loss of gold and silver, and was consequently to be avoided. The outstanding task of public policy became, therefore, the encouragement of exports and the discouragement of imports.

One obvious way to evolve a "favorable balance of trade" was to force a reduction in imports. Imports might be reduced indirectly by encouraging the consumption of home-produced goods by sumptuary laws and by subsidies and other aids to home industry, or directly by discouraging the use of foreign-made goods. When the Reformation reduced the demand for fish, the complaints of the herring industry induced Edward VI of England to decree that fish be eaten during Lent. In 1571, when fashions in headgear were changing, Parliament ordered all persons over six years of age, excepting ladies and gentlemen, to wear wool caps on Sundays and holidays in order to placate the cap-makers. The lamentations of woolen manufacturers over the lack of markets and the growing popularity of competing fabrics led Parliament in 1666 to legislate that no person should be buried in any shirt or sheet other than one made entirely of wool. Positive aid and encouragement to domestic industry was given by granting a monopoly, giving a bounty, providing some of the capital, or granting exemptions from taxation or guild restraints. Maria Theresa of Austria subsidized porcelain plants in Vienna and textile works in Bohemia. England gave bounties on whaling and fishing boats, sailcloth, rope, silk, and linen.

## 24 International Trade and Commercial Policy

From the sixteenth century on, imports were directly reduced by tariffs and import prohibitions; imports of manufactured goods were the most severely cut.

*Bounties and the Migration of Workers.* While the balance of trade might be tipped in favor of a particular country by reducing its imports, the balance might be still further tipped by also increasing its exports. Various devices were employed to the latter end.

Extensive bounties and subsidies were granted to industry and agriculture, and encouragement was given to the immigration of skilled craftsmen. England, for example, granted in 1673 a bounty on the export of corn in order to stimulate the home production of, and to make herself self-sufficient in, this important food. In 1689 the bounty was renewed, and it remained in effect, except for temporary suspensions, until 1814. Later, export bounties were granted on sailcloth, linen and silk manufactures, beef, salt pork, and other commodities, many of which were not repealed until the nineteenth century. The revocation in 1685 of the Edict of Nantes, under which the Huguenots had been tolerated in Catholic France, cost that country dearly, as these Protestants, who had been in the forefront of economic developments and prominent in banking, industry, trade, and shipping, migrated to England and Holland, taking with them their capital as well as their skill in making silk fabrics, pottery, glass, paper, hats, jewelry, and other goods. The development of the staple industry of England, the manufacture of woolen cloth, owed a great debt to these refugee artisans from the Continent, especially to those from Flanders.

It was also considered beneficial to export manufactured goods and to import raw materials, when the latter could not be produced in sufficient abundance at home, since manufactures were of greater value than raw materials, and the difference must be paid in specie. Raw materials must not be exported if by any means they could be sold abroad in manufactured form, and they should certainly not be exported to competing industrial nations. In 1278, and on many later occasions, France forbade the export of raw wool, and in 1660 England stopped its export entirely. The export of tools and implements and the emigration of skilled artisans were universally forbidden. When their industries had so outdistanced those of rival nations that English workmen were sought after by foreign nations,

the English became so alarmed that they passed laws to prevent the export of machinery, and even of models, drawings, and specifications.

*The Reexport Trade.* To encourage national shipping and trade with foreign countries, without at the same time opening the domestic market to foreign-made goods, the reexport trade was fostered. Drawbacks, i.e., the refunding of duties on imports intended for reexportation, were provided for, and free ports and bonded warehouses established. Imported goods which entered free ports or those which were deposited in bonded warehouses paid no duties unless they were later transferred out of the free zone or warehouse into the country of import; if, instead, they were reexported, a drawback would not be necessary because they had paid no duty. Some writers even urged abolishing import duties and substituting for them excise taxes on the domestic consumption of imported goods as a means of stimulating the reexport trade.

*Labor Policies.* Since the ability to sell manufactured goods in foreign markets in competition with the industries of other countries depended on one's ability to sell cheaply, it was vital that costs of production be kept low. And since the largest item in production costs was usually wages, it naturally followed that wages must be kept low—substantially at the level of subsistence. Sir James Steuart expressed this principle very bluntly when he stated that “the lowest classes of a people, in a country of trade, must be restrained to their physical-necessary.”<sup>9</sup> It was even considered justifiable to pay laborers less than a subsistence wage, if this was necessary to meet foreign costs. Where this was done, the government supplemented the insufficient wage of the workers with poor relief. Another reason for maintaining wages at the subsistence level was the belief that wages above such a level would induce the worker to spend part of his time in idleness and thus decrease the available supply of labor.

<sup>9</sup> *An Inquiry into the Principles of Political Economy*, 1767, I, 502. Cited by Viner, *op. cit.*, p. 56. This policy illustrates perhaps more clearly than any other the sharp contrast between the position of the individual in the mercantilist state and in the liberal democratic state. In the former, the individual existed only for the greater glory of the state; in the latter, the state is created to promote the welfare of the individual. The mercantilist state of the seventeenth century has had its modern counterpart in Nazi Germany, Fascist Italy, and militaristic Japan.

## 26 International Trade and Commercial Policy

A corollary to the doctrine of a subsistence wage was the demand for a large working population. The mercantilists well understood that an abundant supply of any commodity, even labor, assured a low price for that commodity. Bounties were even offered to stimulate population growth. German fathers of large families were paid premiums, and in France the nobleman with ten children was given a pension of a thousand livres.<sup>10</sup>

*Colonies.* Two other important groups of mercantilist policies evolved around the quest for colonies and the encouragement given to the merchant marine. Colonies might be the direct source of gold and silver, as, for example, the Mexico and Peru of Spain and Portugal's Brazil; or they might produce non-competitive products which could be monopolized by traders of the mother country and re-exported in exchange for gold and silver. In the latter category were the spices from the East Indies, the silks and cottons from India, the furs from New France and the English colonies, and the tobacco from Virginia and Maryland.

If the colonies possessed no gold or silver mines or produced no exportable staple, they might nevertheless prove their worth to the mother country as markets for the surplus manufactures of the homeland or as suppliers of necessary raw materials which the mother country could not produce, or could produce only in insufficient quantities. But if the colonies were to furnish markets for the manufactures of the homeland, the development of competing colonial manufactures must be prevented. The English Parliament passed acts prohibiting the manufacture of colonial woollens for the market. In 1732 the making of hats in the colonies was restricted, and after 1750 the manufacture of ironware and steel was forbidden.

On the other hand, the direct stimulation of certain colonial industries which would complement the economy of the mother country might be necessary. England encouraged the smelting of iron in the colonies by the removal of duties on the importation of colonial pig iron into the mother country. The production of other goods, e.g., naval stores, masts for the British navy, hemp, raw silk, and

<sup>10</sup> Heaton, *op. cit.*, p. 391. Similar encouragements to large families and a large population were offered in the years before World War II in Italy and Germany, two modern nations in which the spirit of Nationalism has been strong, which have had insatiable imperialistic ambitions, and have sought a large military force.

indigo, was directly encouraged by the granting of bounties. The supplying of these products by the colonies would reduce or eliminate Britain's need for importing them from foreign nations, and would check to that extent the outflow of specie.

*The Merchant Marine.* A strong merchant marine was to be desired for two reasons. In an era when international rivalries were keen and naval wars not infrequent, a large merchant marine might be a valuable adjunct to the navy, especially in a period when naval vessels were not as highly specialized as today. A merchant marine might also be an instrument for increasing a nation's supply of bullion. The transportation of one's own goods made it unnecessary to buy shipping services from foreign powers, which would occasion a loss of specie, while the transportation of goods for other countries would obligate the latter to reimburse the carrying nation in specie. This recognition that the services of merchant marines would lead to an international flow of specie represents a marked advance over the earlier and cruder notion that it was only the excess of imports or exports of *merchandise* which was responsible for bullion movements between nations. But while most mercantilists by the eighteenth century realized that a "favorable" balance of trade must take into account, in addition to mere merchandise movements, such transactions as shipping services, tourists' expenditures, payments to ambassadors abroad, and other "invisible" items, they still continued to emphasize the desirability of a "favorable" balance of trade in the narrower sense of the mere movement of goods.

If a merchant marine was to be profitably employed, foreign commerce was essential. Colonies were a means of assuring foreign commerce for the national merchant fleet, for colonial routes could be monopolized for exclusive service by one's own ships. Such monopolization of the colonial trade was the purpose of the English Acts of Trade and Navigation of the seventeenth century. Domestic shipbuilding and the training of seamen, too, were stimulated by the monopoly of the colonial trade, and also by granting a monopoly of coastwise shipping to home ships and by regulating the fisheries in favor of domestic fishermen, either by excluding foreign fishermen from home ports or by levying discriminatory duties on the ships of aliens bringing fish to home ports. By means of such regulations the English undertook to outstrip and cripple the shipping power of the

## 28 International Trade and Commercial Policy

Dutch, who had succeeded in reducing the cost of shipbuilding and ship operation to such an extent that they were able decisively to underbid rival merchant marines. And because mercantilism implicitly assumed that one nation could gain only at the expense of another, the Dutch loss was regarded as a British gain.

### THE EBB OF MERCANTILISM

The tide of mercantilism began to ebb in different countries at different times. When mercantilist policies were being belabored and mercantilist doctrines were losing face in such industrially advanced countries as England and France, they were still displaying vitality in such economically backward countries as Prussia, Spain, Portugal, and Russia. But by the eighteenth century, commercial and manufacturing groups were discovering that their interests would be better served by a relaxation of the multiple controls of the mercantilist state, and writers were exposing the economic fallacies of the old order and expounding a strange, new gospel of *laissez faire*.

Mercantilist regulation broke down when it no longer fitted the needs of trade and industry, and could therefore no longer be enforced. State controls had benefited the merchants and manufacturers of the sixteenth and seventeenth centuries by destroying the local restrictive regulations imposed upon trade and industry by the guilds, municipalities, and provinces, by protecting them from foreign competition, and by creating for them colonial monopolies. But the burst of productive energy and the expansion of markets which were beginning to unfold by the late eighteenth century—occasioned by the new inventions, techniques, and industrial and business organization, the improvements in transportation, the increase in population, and the evolution of credit instruments—could not realize their fullest development in the strait jacket of mercantilism. Apprenticeship and sumptuary laws, laws regulating wages, methods of production, and the use of machinery, laws limiting the freedom of choice of occupation and the number of workers in a trade, and laws restricting or prohibiting imports were not conducive to greater production and wider markets. Rival European nations might, after all, be more helpful as markets than dangerous as competitors.

When the groups that had been the chief beneficiaries of mercantilist policies realized that these policies were no longer working to their advantage, but were, in fact, a positive hindrance to the development of business, these policies were altered, and the structure of mercantilism began to crumble. As early as the third quarter of the eighteenth century internal restrictions began to disappear. Actually, many had been inoperative long before they were legally repealed. Tariff barriers began to be reduced in England in the 1820's, and by the 1860's great breaches had been opened in tariff walls throughout practically all of western Europe—breaches which, however, were to be repaired and strengthened in the decades following 1880.

During the period when invention was revolutionizing industry and trade, new political and economic doctrines were reevaluating the respective roles in society of the individual and the state. Locke, Rousseau, and Jefferson were challenging the theory of the divine right of kings and the claim of the state to omnipotence; they were preaching in opposition the new doctrines of natural rights and social contract. Government, according to these seventeenth and eighteenth century political philosophers, is not a divine creation, but an institution established by the governed to secure their natural and unalienable rights of life, liberty, and property. When any form of government becomes destructive of these ends, it is the right of the people to alter or abolish it and to institute new government, laying its foundations on such principles and organizing its powers in such form as to them shall seem most likely to effect their safety and happiness. It is not the right of the state, either, to decree a particular religion; rather, each individual possesses the right to worship his own god in his own way.

The reaction against authority in respect to political life extended inevitably to economic life. In the middle decades of the eighteenth century a group of French economists known as the physiocrats announced to the world that economic life was based on a natural order. To them, the general welfare as well as individual welfare was best served when government granted full sway to this natural order and allowed each individual to seek his own interest under the competitive conditions of a free market. This free market could be established only by repealing the monopolistic and restrictive policies of mercantilism. The only proper function of government, ac-



### 30 International Trade and Commercial Policy

ording to the physiocrats, was the maintenance of the conditions which they regarded as essential to the functioning of the "natural order." We are indebted to the physiocrats for the term *laissez faire*.

The most forceful and influential prophet of *laissez faire* was Adam Smith, who, with compelling argument and apt illustration, demolished the entire mercantilist philosophy and erected in its stead an economic philosophy which guided statesmen and economists for over a century before it was seriously challenged. Granting no quarter, he pitilessly exposed the whole gamut of mercantilist fallacies: the doctrine of the balance of trade, the identification of money with wealth, restraints upon imports, bounties on exports, compulsory apprenticeship, the old colonial system. Against the view that national welfare demands the continuous intervention of the government, he, like his French contemporaries, opposed the philosophy of individualism.

As every individual endeavors as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own gain, and he is in this, as in many cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.<sup>11</sup>

Obviously, if an "invisible hand" guides selfish action to public good, state control of industry and commerce is unnecessary, to say the least. According to the system of natural liberty, the sovereign has only three duties to attend to: defense against invasion and internal violence, the exact administration of justice (for the protection of the citizens against injustice and oppression), and the sup-

<sup>11</sup> *Wealth of Nations* (Everyman's edition), I, 400.

port of certain public works and institutions necessary for the general welfare but beyond the scope of private initiative, since they offer no promise of profits.

The notion that one nation can become rich only at the expense of another, Adam Smith effectively exploded by demonstrating that trade is mutually advantageous. Just as the division of labor among individuals results in a greater total production for the individuals as a group, and consequently a larger income for each individual, so the international division of labor leads to greater world production, and consequently to a larger income for each nation. In this way did Smith reveal the fundamental basis of international trade and the source of the gains from trade. Upon these foundations laid by Adam Smith in 1776 the economists of the nineteenth and twentieth centuries have erected the modern theory of international trade.

### MODERN MERCANTILISM

The spread of the Industrial Revolution and the publication of the *Wealth of Nations* did not finally relegate mercantilist doctrines to the limbus of the late eighteenth century. These doctrines proved to possess a remarkable vitality, and provide the theoretical foundation for many contemporary policies. The influence of mercantilism is seen today in the widespread distaste for large imports—attested by world-wide high tariffs, import prohibitions, quotas, exchange controls, and buy-at-home campaigns—and in the popular belief that large and increasing exports are a sign of economic health and vigor. Japan's "China Incident" and "East Asia Co-Prospcrity Sphere," Italy's conquest of Ethiopia and invasion of Albania, the clamoring of Hitler and Mussolini for colonies, and the stolid reluctance of British and French statesmen to disgorge any portion of their respective empires, testify to the importance placed upon colonies in the modern world. No modern nation which aspires to a place in the sun, furthermore, feels that it can afford to be without a merchant marine, even though maintaining one necessitates large state subsidies. Finally, the world wars of 1914 and 1939 are strongly reminiscent of the struggles for empire among the mercantilist states of the sixteenth, seventeenth, and eighteenth centuries.

## 32 International Trade and Commercial Policy

### CRITIQUE OF MERCANTILISM

The economic and monetary theory developed in the chapters immediately following presents a set of keen tools for a more detailed appraisal of commercial policies in general. Here, a few general observations on mercantilist doctrines may be made.

In recent years there has been a tendency among economic historians and German economists to defend mercantilist doctrines from the attacks which economic theorists have been leveling at them since the early nineteenth century. It has been argued, for example, that a thorough knowledge and understanding of European political and economic conditions during the centuries when mercantilism held sway will go far in explaining such policies, and, presumably, in justifying them. Professor Viner has effectively controverted this argument by observing that the acceptance of this view would "lead to the conclusion that no age, except apparently the present one, is capable of serious doctrinal error. . . . More specifically, to be invoked successfully in defense of mercantilist doctrine it needs to be supported by demonstration that the typical behavior of merchants, the nature of monetary processes, and the economic significance of territorial division of labor have changed sufficiently since 1550, or 1650, or 1750, to make what was sound reasoning for those earlier periods unsound for the present-day world."<sup>12</sup>

Another argument advanced in answer to the critics of mercantilism is that the primary objective of mercantilist policy was not economic prosperity but national unity and power. But even if it be granted that the chief objective of mercantilism was a great and powerful state, rather than one which is wealthy, it does not follow that an appraisal of these doctrines on economic grounds is unwarranted. For there is little evidence that mercantilists found any conflict or discordance between power and wealth. On the contrary, common approval was given by mercantilists to Child's statement: "Foreign trade produces riches, riches power, power preserves our trade and religion." A good deal of mercantilist literature, moreover, seems to be special pleading for limited economic interests—rich

<sup>12</sup> *Studies in the Theory of International Trade*, Harper & Brothers, 1937, pp. 110–111. For the material in this and the following paragraphs I am indebted to Professor Viner's work.

merchants, the East India Company, and even agricultural interests—rather than an admitted sacrificing of economic interests to political interests.

The *coup de grâce* to mercantilism came, however, when the development of the quantity theory of money and the erection of the modern theory of international prices removed its logical foundations. Before the close of the seventeenth century, Dudley North had revealed that money tends to become automatically distributed among nations according to the needs of trade, and John Locke had formulated a clear-cut theory of money showing that the price level of a nation depended upon the quantity of money in that country in relation to its supply of goods. Locke even went a step further and declared that prices in two different countries could not be too far apart, otherwise the country with low prices would transact much trade and the one with high prices, little. But it was not until the middle of the next century that these fundamental doctrines were synthesized by David Hume into a complete theory of international prices, a synthesis upon which the economists of the nineteenth century based their theory of international prices and trade.

Using the tools shaped by his predecessors, Hume demonstrated that no nation need worry about securing a sufficient supply of specie, because its trade with other nations would automatically assure it of the amount needed. If England, he began, should suddenly be deprived of four-fifths of its gold and silver, the first result would be that the prices of all commodities and labor in that country would be forced down in proportion, and be forced down relative to prices in other countries. But the very fall of prices would stimulate foreign purchases of its products, and at the same time cause its nationals to reduce their purchases of foreign products. This "favorable" shift in the balance of trade would lead to an appreciation of its currency in relation to foreign currencies, which in turn would lead to an inflow of specie. The inflow of specie would induce a rise in the prices of labor and commodities, and would continue until prices in this country had been forced high enough relative to those in other countries so that exports and imports would be in balance and no further specie flow would be necessary. Thus, the temporary advantage of low prices in the country would be wiped out, and its price level and supply of money would attain

## 34 International Trade and Commercial Policy

such levels as were justified by its art and industry. In brief, a redundancy of money would be corrected by high domestic prices and a loss of specie, an insufficiency by low domestic prices and the importation of specie. Money was thus revealed to be merely an instrument of exchange rather than wealth par excellence; it was shown that the quantity of money held by a nation would itself affect the balance of trade, and would also be controlled by it. In such fashion were the fallacious mercantilist doctrines of money and the balance of trade scuttled.

The wealth of a country does not consist of gold and silver alone, but of the sum total of all kinds of goods, including gold and silver. Gold and silver constitute one form of wealth, but only one form, and certainly not the most important. Except for their uses as money, the uses of the precious metals are quite limited—mainly for plate, jewelry, and dentistry. And even the monetary uses of gold have been narrowed since World War I. That nation would be considered poor indeed which had an abundance of gold but little of other goods, when compared with the nation scantily supplied with gold but possessing an abundance of food, houses, factories, clothing, coal mines, modern highways, railroads, automobiles and trucks, airplanes, amusement halls and parks, hydroelectric plants, and so on. Of course, if the nation rich in gold could exchange its gold for other goods, it could acquire wealth; but its wealth would consist of what it acquired rather than its gold. The faith of Americans in gold has been somewhat shaken by our recent accumulation of a vast hoard of more than twenty billion dollars of the metal, more than 60 per cent of the monetary gold in the world. Are we on that account richer than we were in 1930, when our gold reserves amounted to only about one-sixth of their present value? Of what value to us would our great reserves of gold be if the rest of the world should demonetize the metal?

The fallacies underlying mercantilist doctrines can be more easily understood after an analysis of foreign exchange and an examination of the theory of international trade. To these tasks we turn in the seven chapters following. The remainder of the book is devoted to a description and an appraisal of modern commercial policies. The mercantilist influence will be readily recognized in many of these more recent policies.

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## ***Foreign Exchange: The Mechanism of International Payment***

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Viewed as a whole, international trade is barter. The goods and services which a nation imports from foreign nations are paid for by the export of domestically-produced goods and services. Likewise, a nation receives payment for those goods and services which it exports in the form of imports of goods and services. In the long run, a nation's imports must be limited by her capacity to export goods and furnish various types of services to other nations.

If international trade were carried on by nations as units, goods could simply be bartered against goods and no problem of international payment need arise. But international trade has been largely transacted between individual business men or firms, and the individual business man ordinarily sells for money and buys with money; barter he would find too cumbersome. Even where foreign trade has been conducted by government agencies, these agencies have rarely resorted to barter; instead, they have preferred to carry on their business like commercial enterprises, buying with and selling for money. Consequently, where international trade is carried on, international payments have to be made.

Making payment to an individual in a foreign country, however, presents problems not faced, or faced in a different way, in making payment to an individual in one's own country, viz., payment in a foreign currency and payment at a distance. To discharge a domestic debt, it is necessary only to tender to the creditor on the spot domestic currency or a check drawn on a domestic bank. But when the debtor and the creditor reside in different countries, the debtor cannot discharge his debt in this way; for the local currency of his

country does not ordinarily circulate in the creditor's country and is consequently not acceptable to the creditor. The debtor must, therefore, find some means of converting his currency into the foreign currency.

The need for making payment at a distance is not peculiar to international trade; it is also present in domestic trade. In domestic trade, however, such payment has been made as easy as local payment through the development of a national clearing system by the central bank, an institution with which practically all countries are today provided. All that is necessary is for the debtor to mail the creditor a check on his (the debtor's) bank; so far as the debtor is concerned, his debt is thereby discharged. But distance in international payments cannot be overcome by mailing a personal check on one's bank because there is no international clearing house for the collection of such checks.<sup>1</sup> If the two countries concerned have a common monetary standard, e.g. gold, the debtor can liquidate his foreign obligation by shipping the acceptable medium.<sup>2</sup> But the costs of shipment ordinarily make payment by this means unduly expensive. Special methods for transferring funds between nations have, therefore, been developed.

The principal functions of foreign exchange are, thus, to convert the currency of one country into that of another and to facilitate payment at a distance across national boundaries. But foreign exchange performs another function, one, however, not peculiar to foreign finance. It permits the buyer to postpone payment. Foreign exchange, more specifically, makes it possible for an importer in the United States to pay for imported goods (1) with dollars, (2) in his own country, (3) one, two, three, or more months after he has received the goods; and at the same time it enables the exporter in England, say, to receive his payment (1) in pounds sterling, (2) in London, (3) immediately after he has loaded the goods for shipment.

<sup>1</sup> The work of such an international clearing house would, of course, be greatly complicated by having to convert one national currency into another, although provision for meeting this difficulty was provided in both the Keynes and the White plans for an international stabilization fund.

<sup>2</sup> Even though the countries are not on the gold standard, gold, and silver too, can often be bought and sold as a commodity and shipped as a means of payment.



**FINANCING FOREIGN SHIPMENTS**

To illustrate how money-changing, payment at a distance, and credit extension are accomplished by the foreign exchange market,<sup>3</sup> let us trace the complete financing of a typical export transaction.<sup>4</sup> Suppose that the United States Exporting Corporation in New York has entered into a contract with the British Importing Company of London, according to which the former agrees to ship the latter a specified quantity of wheat. The British concern agrees to pay £1000 for the shipment, and the American exporter, in turn, agrees to permit the importer to postpone payment for 90 days. Although the exporter has arranged for the importer to delay payment for 90 days, he wants his money just as soon as he has loaded the goods on the ship, because he does not have the funds with which to extend the credit himself.

As soon as the exporter has loaded the goods for shipment, he will draw a draft (bill of exchange) on the importer for £1000 sterling payable 90 days after sight. A draft is simply an order drawn by one party (the drawer), directing a second party (the drawee) to pay a third party (the payee) a specified sum of money at a certain, or determinable, time. The bill of exchange, in appearance and function, resembles the common bank check, as may be seen from Figure 1. To the draft the exporter will attach certain shipping documents, chief among which are the ocean bill of lading, marine insurance certificate, commercial and consular invoices, and hypothecation certificate. The exporter will then present the draft with attached documents to his bank, which will buy it at the bank's buying rate for bills of such type and maturity. Thus, the exporter receives payment in his native money, in his own country, and immediately upon the shipment of the goods.

The bank, in the meantime, has paid cash, or more properly, has created a deposit in favor of the exporter, in return for a claim upon a foreign corporation for the payment of a specified sum of a foreign

<sup>3</sup> "Foreign exchange" means claims to foreign money. More commonly, the term is used to refer to the physical evidences of these claims, viz., bills of exchange.

<sup>4</sup> It should be pointed out that, although the method of financing herein described is fairly typical, it is not the only method employed. Other methods are described later in this chapter.

currency at a future date. The bank is protected from loss on the transaction in two ways. It has the written endorsement of the drawer which makes him legally liable for payment of the draft if it is not otherwise paid, and it has possession of the bill of lading and other documents which the exporter has attached to the draft. The bill of lading is the receipt for the goods given by the steamship company, and it also gives title to the goods. Whoever holds the bill of lading, and *only* he who holds it, can secure possession of the exported merchandise.<sup>5</sup>

£1,000/0/0	New York, January 2, 1946
<u>Ninety (90) days after sight</u> of this	
First of Exchange (second unpaid) pay to the order of The United States Bank of New York <u>One thousand pounds sterling</u>	
value received which charge to the account of <u>To</u>	
<u>British Importing Company</u> <u>London, England</u>	<u>(Signed)</u> <u>United States Exporting Corporation</u>

FIGURE 1. A Commercial Bill of Exchange.

The bank will immediately mail the draft with attached documents to either its foreign branch or its correspondent bank in London; the latter will promptly notify the importer and present the draft to him for acceptance. The importer (drawee) accepts the draft by writing the word "accepted" across the face of the instrument above his signature and by dating the acceptance. The importer cannot secure the bill of lading, without which he cannot obtain possession of the goods, unless and until he accepts it. By accepting the bill, he becomes legally bound to pay the obligation when it matures. It should be noted that when the draft is made payable at a certain period "after sight," the date of acceptance fixes definitely the maturity date. The accepted draft is known as a "trade acceptance."

<sup>5</sup> The so-called "straight" bill of lading calls for the delivery of goods to a designated consignee, regardless of whether or not the consignee has the bill of lading. The "order" bill of lading, properly endorsed, gives the *holder* the right to take possession of the goods.

## 40 International Trade and Commercial Policy

Upon securing the drawee's acceptance, the correspondent bank will deliver the attached documents to the acceptor (who is also the drawee and the importer), and will then discount the acceptance in the open market. If the market rate of discount on such acceptances is for example, 4 per cent per annum, the discount on a 90-day acceptance for £1000 will amount to £10, and the London bank will receive £990 net for the bill. This amount will be credited on the books of the London correspondent bank to the account of the New York bank. If the New York bank's buying rate for 90-day, documentary, commercial bills at the date of export is, say, \$4.80, it pays the exporter \$4800 for the £1000 bill. The New York bank thus pays out \$4800 in American currency, and acquires £990 in British sterling.

As a dealer in foreign exchange, the New York bank finds it necessary to maintain a deposit account with the London bank; yet it will not ordinarily wish to increase this London balance above what it considers to be a working minimum. To do so will only subject it to the risk of exchange, i.e., to the danger of loss in case the sterling rate (the dollar price of pounds sterling) in New York falls. Consequently, it will *immediately* convert this added balance of £990 into dollars. It can do this by drawing banker's sight drafts against its London balance; these sight drafts can be sold in the United States to importers and others who have payments to make in England.<sup>6</sup> The banker's sight draft resembles the familiar bank check, but it is drawn by a bank instead of by an individual or a business firm.

The New York bank avoids any risk of loss from a possible fall in the exchange rate by offsetting all purchases of exchange by sales of equivalent amounts. That is, at the same time that it purchases the 90-day commercial draft for £1000, the bank sells £1000 worth of banker's sight drafts. It is able to sell sight drafts before the commercial bill has been discounted abroad because the sight drafts cannot reach England before the commercial bill does. There will consequently be time to secure the importer's acceptance of the commercial bill, to discount the acceptance, and to have the New

<sup>6</sup> If the bank is unable to sell all its acquisitions of foreign exchange, its foreign balances will, of course, increase. The increase in bankers' foreign balances will cause foreign exchange rates to fall, and may result in the importation of gold.

York bank's account credited with the proceeds before the sight drafts which have been sold to importers are presented for payment in London. The bank similarly avoids a possible loss from a rise in the exchange rate, when it sells exchange, by matching its sales with simultaneous purchases, in equivalent amounts.

The foreign exchange dealer (the New York bank) makes his profit on the transaction from the spread between the rates on commercial long bills and banker's sight bills. The rate on banker's sight bills is higher than that on commercial long bills because of the higher credit standing of the drawer, and the shorter maturity. When the rate on 90-day commercial bills is \$4.80, for example, the rate on banker's sight bills will be, say, \$4.86. So when the New York dealer purchases a £1000 90-day commercial bill at \$4.80, total price \$4800, he will also sell £990 sight sterling at \$4.86, for which he receives \$4811.40. His profit on the transaction will therefore be \$11.40. In making the transaction, it must be noted, he has advanced no funds and taken no risk of exchange.

Since the exporter has received his payment upon shipment of the merchandise, and since the English importer does not have to meet his acceptance for 90 days, somebody has had to advance the funds for the 90 days. Who is it? The answer is: the English investor who has discounted the acceptance. This investor is some English bank, bill broker, discount house, or institutional or private investor. He has parted with £990, and will not receive payment for the acceptance until it matures 90 days hence, and by that time the importer will have acquired the cash to meet his acceptance through sale of the wheat. At maturity, the investor will be paid £1000, although he advanced only £990. The £10 difference, or the discount, is his payment for advancing the funds.

Foreign trade financing thus rests upon the possession of surplus funds by institutions or individuals who are willing to invest them in international bills of exchange. It was the possession of such a pool of liquid capital ever available for investment in foreign trade bills that made London the financial center of the world prior to 1914.

The exact duplicate, in the reverse direction, of this transaction evolves when American imports from England are financed by similar means. Here, the British exporter will draw a long draft on the

## 42 International Trade and Commercial Policy

American importer in *dollars*. This he will sell to a London bank, which, in turn, will mail the bill to New York for acceptance and discount, thus building up its dollar balance in its New York correspondent bank. The British exporter, in this case, receives immediate payment, in London, in pounds sterling. The London bank pays out cash, or increases its domestic deposits, and at the same time increases its New York balance. An American investor discounts the accepted bill and finances the shipment, thereby making it possible for the American importer to postpone payment until the maturity date of the acceptance. Like the New York bank in the preceding case, the London bank will match against its purchase of commercial long bills from exporters the sale of sight drafts to importers. The role of a clearing house for foreign debts and credits, played in the first case by the New York bank, is in this one played by the London bank. Foreign credits, originating in the export of goods, the bank takes over by building up its foreign balance and by expanding its domestic deposits. Foreign debts, arising from the import of goods, it liquidates by drawing against its foreign balance and reducing its domestic deposit liabilities.

The initiative in the matter of payment may be taken by the importer instead of by the exporter, as it was in the two preceding cases. The British importer in our first case, instead of having the exporter draw on him, might have purchased a banker's dollar draft for remittance to the American exporter, either in advance of shipment or upon receipt of shipment. In such a case, the shipment would usually be invoiced in the currency unit of the exporter's country. The ability of the London bank to sell dollar drafts will depend, of course, upon its having previously built up a New York balance through the purchase of exporters' bills. Which particular method of payment is employed will be decided upon by agreement between the importer and the exporter at the time the contract is made.

### FOREIGN EXCHANGE ESSENTIALLY AN OFFSETTING OF FOREIGN DEBTS AND CREDITS

The transactions described in the preceding section show how the foreign exchange market makes it possible for an individual in one

country to pay an individual in a foreign country without any international movement of money (gold), merely by offsetting foreign debts against foreign credits. The foreign exchange dealer, in other words, performs the function of an international clearing house, operating through his balance with his foreign correspondent. This offsetting of foreign credits against foreign debts is the essence of foreign exchange. The student who grasps the principle clearly will have little difficulty in understanding the most complicated transactions in foreign exchange.

The individual bank may find that on a particular day its foreign balance threatens to become larger than it desires because its customers offer to it for sale a greater volume of foreign exchange than other customers want to purchase, or smaller than it desires because customers want to purchase more exchange than other customers offer for sale. The bank can reduce this surplus by selling its excess of foreign exchange to other banks which may be faced with a deficit, or avoid a deficit in its foreign balance by purchases from banks possessing a surplus. So, even if a single dealer cannot effect a perfect clearance on a particular day, all the dealers in a country, by pooling their excesses and deficiencies of exchange, may be able to effect a perfect clearance for the nation.

A perfect clearance may be consummated even though the supply of bills offered on a given country may exceed the demand for bills on that country, if at the same time the demand for bills on a third country exceeds the supply of bills on the third country. Before the war, for example, American exports to the United Kingdom ordinarily greatly exceeded imports from the United Kingdom, while American exports to Brazil were much smaller than exports to Brazil. Thus the United States possessed a surplus of sterling exchange, but was deficient in Brazilian exchange. At the same time, Brazil's imports from the United Kingdom exceeded her exports thereto, so that she was faced with a deficiency of sterling exchange. Brazilian exporters were only too glad, therefore, to accept payment for their exports to the United States in sterling, for Brazilian importers were ever ready to buy sterling to discharge their debts to British exporters. Through this triangular clearance, American exports to the United Kingdom provided the means of paying for

## 44 International Trade and Commercial Policy

American imports from Brazil. When a perfect clearance cannot be achieved through three countries, it frequently can through four, or five, or more.

But at times a nation's imports from all countries may exceed her total exports, so that there is a deficiency in all her exchange dealings on merchandise and service account. If the deficiency promises to be only temporary, the necessary exchange may be acquired by borrowing from some foreign bank, and the loan can be repaid later when the trade balance again becomes favorable. Thus, a perfect clearance is effected by offsetting an exchange surplus of one date against a deficiency of a later date. If, however, the total foreign payments to be made exceed the offerings of foreign bills by exporters, and if at the same time foreign exchange dealers are for some reason—higher interest rates abroad than at home, or the fear that foreign exchange rates will be unfavorable in the future when the foreign loan must be repaid—unwilling to negotiate a foreign loan, the deficit in the supply of foreign exchange must be made up by the export of gold.<sup>7</sup> If there is a surplus instead of a deficiency of exchange, dealers may be willing temporarily to increase their foreign balances. If they are not, gold will be imported. Payment will always be made in the cheapest medium. But considering all of a country's international transactions, the great bulk of the balances will normally cancel out, leaving only a small amount to be settled in gold. When the world is undisturbed by economic or political crises, the international flow of gold is but an infinitesimal fraction of the total volume of international trade.

### TYPES OF BILLS OF EXCHANGE

Reference has been made in the preceding sections to banker's bills and to commercial bills. A banker's bill, or banker's draft, is a bill drawn by one bank on another bank. A commercial, or trade, bill is one drawn by an individual or business firm, generally an exporter, upon another individual or firm.

<sup>7</sup> If the country is not on the gold standard, so that gold cannot be obtained at a fixed price, the scarcity of foreign exchange will cause foreign exchange rates to rise. The rise in exchange rates will tend to curb the demand for exchange and call forth a greater supply. This point is discussed at length in the following chapter.

Bills may also be classified according to usance, i.e., the length of time the bill has to run before payment. Bills payable immediately upon presentation to the drawee are known as sight or demand bills, those which run for various periods of time, as time bills. Time bills drawn for a period longer than 30 days are called long bills, while those drawn for a period of 30 days or less are short bills. Few foreign bills of exchange are drawn for longer than 90 days, except in the South American trade. A common form of international remittance is the cable, or telegraphic transfer. This is a telegraphic order by a bank to its foreign correspondent, which instructs the foreign bank to pay a designated payee a certain sum of money and to charge it to the drawer bank's deposit account. By this means an international remittance can be made within twenty-four hours.

Bills may finally be classed as clean or documentary. Clean bills are unaccompanied by documents; documentary bills have attached to them the essential documents of international finance enumerated in an earlier section, viz., bill of lading, marine insurance certificate, and commercial invoice, frequently together with consular invoice, hypothecation certificate, and certificate of origin. Banker's bills are always clean bills. Trade bills may be either clean or documentary. Clean trade bills, however, afford less security than documentary trade bills because the documents, when properly executed, give control over the shipment and make it readily possible to transfer title to the goods. In international trade the documentary bill is used almost exclusively, since banks usually refuse to buy or discount clean trade bills. Whether the merchandise financed by a documentary bill will be surrendered to the importer upon his mere acceptance of the draft, or not until he makes payment, will depend upon whether the arrangements provide for "documents against acceptance" (a D/A bill) or "documents against payment" (a D/P bill).

#### ALTERNATIVE METHODS OF FINANCING FOREIGN SHIPMENTS

In the case previously described, the financing of the shipment was done by the person who discounted the accepted bill in the country on which the bill was drawn. Other parties to the transac-



## 46 International Trade and Commercial Policy

tion may, however, do the financing. The importer, for example, may carry the entire burden of the financing. In certain instances, he may remit in the exporter's currency at the time he orders the merchandise. Prior to 1931, full prepayment was required only of importers whose credit standing was unknown or unsatisfactory. Since that date, full prepayment has been frequently imposed on importers in countries with foreign exchange restrictions. In other cases the importer may be required to pay cash against documents. When this is the case, he deposits with a bank in the exporter's country the stipulated sum, which is paid to the exporter when the latter surrenders the proper shipping documents.

The burden of the financing may, on the other hand, be assumed by the exporter. When he consigns goods for sale to his representatives abroad, the foreign representatives will remit a banker's sight draft when the goods are sold. In this case, the exporter not only finances the shipment but assumes the risk of exchange as well. When goods are sold on open book account, the exporter again awaits remittance by the importer. Since the exporter must rely upon the integrity of the importer, foreign sales on open book account are made only to old and reliable customers. Some trade bills, finally, carry such a risk of loss that bankers refuse to buy them, and will take them only for collection at the drawer's risk. In such cases, the exporters must await collection before receiving payment.

Certain arrangements are sometimes made whereby the exporter's bank finances the sale. Under an "advance collection," the exporter and the bank jointly finance the transaction. The bank takes the documentary bill for collection, but at the same time grants the exporter an advance of a certain percentage of the invoice, depending upon the character and marketability of the merchandise. The bank may, on the other hand, arrange a "refinancing acceptance": at the time the exporter gives the bill and documents to the bank, he draws a clean bill on the bank which the latter accepts. This refinancing acceptance is a banker's acceptance, which the exporter can sell in the open market at a rate lower than the customer's rate. At maturity, the refinancing acceptance is retired with the proceeds of the trade bill. Financing is also done by the exporter's bank when the bank chooses to hold until maturity trade bills which it has purchased and has had accepted, instead of discounting them.

## THE LETTER OF CREDIT

The ordinary trade bill, described in our first case, carries no assurance that the importer will accept the draft when it is presented, or take the merchandise when it arrives. Exporters ordinarily insist, therefore, that importers arrange for the issuance of a commercial letter of credit, which provides the maximum of protection to the exporter.

A letter of credit is a document issued by a bank, which guarantees that the bank will accept drafts drawn under it by the exporter up to a certain maximum amount and under stipulated conditions. When the exporter draws a draft under a letter of credit issued by an international bank of high repute, he is assured that he will be paid. For the bank is legally bound to accept the draft, if it is drawn according to the letter's instructions, and the resulting banker's acceptance will be readily discountable at the most favorable rates. Thus, the draft drawn under the letter of credit is superior to the ordinary commercial draft in two respects: the drawee (a bank) is legally bound to accept it, if properly drawn, and the credit of the drawee bank is ordinarily much higher than that of the importer.

The use of the letter of credit in international finance may be illustrated by referring back to our first case, in which an American wheat dealer exports a shipment of £1000 to an importer in London. Let us suppose that the exporter, instead of drawing directly on the importer, requests the importer to arrange a letter of credit. The English importer goes, accordingly, to his bank in London and fills out a formal application requesting the bank to issue the desired letter. In the application, he sets forth the terms of the sale and states the documents which are to accompany the draft, the usance, final date of shipment, etc. If the bank decides to issue the credit, the importer signs the letter-of-credit contract in which he agrees to reimburse the bank for all outlays and to give such security as the bank demands. The bank now notifies its correspondent bank in New York and requests the latter to confirm the credit to the exporter. This the New York bank does by informing the exporter that an irrevocable and confirmed letter of credit has been arranged and by describing the terms under which the shipment must be made

## 48 International Trade and Commercial Policy

before the draft will be honored. This makes the contract binding on both the London bank and the New York bank.

The exporter thereupon loads the wheat on the steamship, draws a 90-day draft for £1000 on the London bank, and sells the draft with documents attached to his own bank in New York. This New York bank mails the draft and documents to its own London correspondent, which, in turn, presents it to the drawee bank for acceptance. The accepting bank keeps the documents and turns them over to the importer, frequently against a trust receipt, an instrument under which the bank retains title to the merchandise and the importer promises to act as agent of the bank and to turn over to the bank all receipts from the sale of the merchandise until full settlement is made. The draft upon acceptance becomes a banker's acceptance, as distinct from a trade acceptance, and is retained by the bank presenting it. The acceptance may then be discounted and the proceeds credited to the account of the New York bank; or the New York bank may, under certain conditions, choose to hold the acceptance until maturity and then collect the full face value of the acceptance.

If the importer resides in a country in which there is no well-organized financial center for the discount of banker's acceptances, and no banks which accept drafts, he may arrange through his local bank for the issuance of a letter of credit on his account by a bank in one of the great international financial centers, e.g., London or New York. Prior to the first World War, a large part of international trade was financed by drafts drawn under letters of credit issued by London banks and then discounted in the London market. A Canadian importer of jute from India, for example, might arrange for a London bank to issue a letter of credit in favor of the Indian exporter, permitting the exporter to draw on London in sterling instead of on the importer in Canadian dollars. In this case the Canadian importer assumes the obligation of providing the London bank with the funds to meet its acceptance before maturity, and thereby assumes the risk of exchange, since it must remit to the London bank in sterling exchange.

The commercial letter of credit possesses distinct advantages over the ordinary trade draft for both exporter and importer. The exporter has a draft of the highest credit rating which can be readily

sold or discounted at the most attractive rates; for him, the credit risk is virtually eliminated. But this very minimizing of the credit risk for the exporter inures to the benefit of the importer, since it makes it possible for the exporter to quote the importer a more attractive price on the goods sold. While the importer must pay the accepting bank a small commission for its services, the lower price obtained from the exporter will ordinarily more than offset this. It should also be noted that the accepting bank does not surrender any funds; it merely lends its name.

The letter of credit used in the above illustration is an "irrevocable letter of credit, confirmed," which means that once issued it cannot be revoked and that it is guaranteed by both the issuing and the confirming banks. An "unconfirmed" letter is guaranteed only by the issuing bank. A "revocable" letter of credit may be cancelled by the issuing bank at any time, and is consequently distinctly inferior to the irrevocable credit. Such letters are rarely issued. A "revolving" letter of credit automatically renews the stipulated amount available to the beneficiary during the period specified. Sometimes the agreement calls for the drawing of a specified sum in a single draft, upon the maturity and redemption of which another draft for the same amount may be drawn. Or a series of drafts may be drawn, but as they mature and are paid, new drafts may be drawn by the exporter; the total amount of unpaid drafts outstanding, however, must not exceed the face amount of the credit. A revolving credit is advantageous when transactions between buyer and seller are continuous and protracted, since it obviates the delay and expense of correspondence for arranging the financial details of each individual transaction.

A "traveler's letter of credit" is sold by banks to persons about to travel abroad. The letter authorizes correspondent banks in other countries to buy drafts drawn by the beneficiary under the letter of credit up to the amount stipulated within the time period specified. The foreign banks buying drafts under the letter of credit are reimbursed by the issuing bank. The traveler reimburses the issuing bank either by payment of cash upon issuance of the credit, by the deposit of securities as collateral, or by signing a guaranty to the bank to pay the drafts he draws as they are presented to the issuing bank for payment.

### DEMAND FOR AND SUPPLY OF BILLS OF EXCHANGE

From the viewpoint of a given nation or financial center, one may regard any foreign exchange operation as either building up or tearing down bankers' foreign balances. Bankers build up their foreign balances by buying commercial bills from exporters; they tear down their foreign balances when they sell bankers' sight bills or cables to importers. In brief, the supply of foreign exchange originates in exports, the demand in imports. In our discussion thus far, the supply of and demand for foreign bills have been shown to emanate only from exports and imports of merchandise. While the most voluminous transactions leading to foreign exchange dealings are usually international movements of merchandise, actually there is a wide diversity of international business which affects the demand for and supply of bills, of which merchandise trade is only a part.

Transactions affecting the demand for and supply of bills of exchange are commonly classified into "visible" and "invisible" items in the balance of international payments. "Visible" items consist solely of merchandise, or goods, i.e., of things which can be seen to move in ships, trains, trucks, or airplanes across national boundaries and into customs houses where they may be counted or measured, and evaluated. "Invisible" items are all other items, such as loans, shipping services, and tourists' expenditures. Invisible items are intangibles, and their enumeration and evaluation usually face pitfalls not present in the enumeration and evaluation of visible items.

The terms "exports" and "imports" are used to refer to invisible items as well as to visible items, and they carry the same meanings for invisible items as for visible items. The basic quality of an export is that it places the nation to whom it is an export in the position of a creditor: foreign nations are under the obligation to pay the nation for all exports. Imports, on the other hand, put the nation in the position of a debtor: the nation is under the obligation to pay foreign nations for all imports. All exports, whether visible or invisible, create a supply of foreign exchange, and all imports a demand for foreign exchange.

A brief examination of the various sources of supply of and demand for bills of exchange will further contribute to an understand-

ing of foreign exchange. It will be helpful to consider that dealings of the United States with the rest of the world are carried on in pounds sterling through the New York-London exchange market, and that the initiative for making and securing payment is taken by Americans. Then all export transactions will give rise to an increased supply of sterling bills and will tend to build up the sterling balances of American bankers in London, while all import transactions will create a demand for sterling bills and result in tearing down the sterling balances of American banks in London.

*Commodity Exports and Imports.* The effects of commodity exports and imports have already been indicated: exports are a source of supply of sterling bills, imports a source of demand.

*Tourists' Expenditures.* American tourists in foreign countries are consumers of foreign products just as much as Americans who consume French champagne and Russian caviar at home are. American tourists abroad travel on foreign railroads, eat foreign food, attend foreign theaters, and buy foreign trinkets to bring home with them. All these foreign goods and services bought by Americans traveling in foreign lands are imports, and give rise to a demand for sterling bills. Foreigners demand payment for services and goods handed out to Americans temporarily expatriated just as they do for the goods they ship to the United States. Foreigners who travel in the United States, on the other hand, consume American goods and services while in this country, and for these they must pay just as they must for goods which we export to them. These expenditures of foreign travelers in the United States are comparable to exports, and create a supply of sterling bills in this country.

*Shipping Services.* American tourists frequently travel abroad on foreign passenger vessels, and American importers often have foreign ships transport merchandise purchased abroad; in fact, before World War I most American tourists and American imports were carried on foreign ships. Since these shipping services must be paid for, they create a demand for foreign exchange; they are imports. The growth of the American merchant marine since 1917 has made it possible for American ships to perform similar services for foreign tourists and foreign importers; the rendering of these services gives rise to a supply of sterling bills.

*Banking and Insurance Services.* Foreign banks, particularly

## 52 International Trade and Commercial Policy

British, accept and discount bills for Americans and perform various services for American banks. Foreign insurance companies issue policies for Americans, especially in the field of marine insurance. All these services must be paid for by Americans; they create a demand for sterling bills. At the same time, American banks render many services to foreign business men and banks, and American insurance companies issue policies to foreigners. These services are exports, and create a supply of sterling bills.

*Immigrant Remittances.* Since the founding of the American nation, tens of millions of foreigners have migrated to our shores, and many of these immigrants have regularly remitted to their families and relatives in the old country substantial sums out of their earnings here. In order to remit abroad, they have to buy foreign bills of exchange. These immigrant remittances constitute a demand for foreign bills, and are hence invisible imports, i.e., debits. During the decades prior to the first World War these immigrant remittances reached high annual aggregates, but the annual totals diminished after the war as immigration quotas sharply reduced the number of new arrivals. Americans employed abroad also remit a portion of their earnings to this country, and these remittances create, of course, a supply of foreign bills here. The flow of immigrant remittances to this country has always been but a small fraction of the flow outward.

*Miscellaneous Items.* Missionary and charitable organizations make payments abroad for the maintenance of foreign missions or relief work, e.g., the Red Cross; these activities add to the demand for foreign exchange. In the same category are foreign expenditures of the United States government—for the maintenance of the diplomatic establishment, etc.—foreign advertising by American companies, the importation of electric power from Canada, legal services and patent and copyright purchases. One important item on the other side of the ledger is royalties for American movie films displayed abroad.

*Earnings on Investments.* Investors in foreign countries have invested large amounts of money in the bonds and stocks of American corporations, upon which they receive interest and dividends, while some foreign corporations have erected branch plants here from which they receive dividends. Remittances to foreign security

holders on interest and dividend account force American corporations to enter the foreign exchange market as buyers of sterling. But Americans, also, have large investments abroad, so that American holders of foreign securities enter the New York market with a supply of sterling.<sup>8</sup>

*Long-Term International Loans.* During the 1920's, investors in the United States loaned to foreign governments and corporations billions of dollars, the making of which loans created a large demand for sterling bills in New York. To the United States, in other words, these loans constituted an import. Now at first glance this may appear contrary to fact, for if A lends to B, does not B owe A? The difficulty may be resolved if it is remembered that a loan involves two different payments: one made today by which B becomes a debtor of A, and one made at the time of repayment in the opposite direction. To make B his debtor, A must turn over to B a sum of money, or its equivalent; twenty years later B clears his debt by paying A. The transaction involved in the *making* of a loan is payment by the creditor to the debtor; the repayment of the loan at maturity involves payment by the debtor to the creditor, an entirely different transaction. Only *after* the capital movement has been completed does the debtor owe the creditor. Perhaps the simplest way of avoiding confusion is to regard the making of a loan as the import of stocks or bonds. For the stocks and bonds imported, the lenders have to pay. American underwriters sell foreign stocks and bonds to American investors, and the proceeds are employed by the underwriters to purchase sterling bills to remit to the foreign borrowers.<sup>9</sup>

When Americans borrow abroad, a practice that was common in the nineteenth century, the American borrowers have a supply of foreign bills to sell in the New York exchange market. The foreign

<sup>8</sup> Payment of interest and dividends to Americans by foreign corporations or governments would ordinarily give rise to an increase in the *demand* for dollars in London rather than to an increase in the *supply* of sterling in New York.

<sup>9</sup> In actual practice, the American underwriters would set up in New York a credit against which the foreign borrowers could draw dollar bills. The effect would thus be to increase the supply of dollar exchange abroad rather than to increase the demand for sterling in the United States. To the extent that the foreign borrowers chose to spend the proceeds of the loan for American goods in the United States, the foreign exchange market would obviously not be affected.



## 54 International Trade and Commercial Policy

underwriters who float the American loans abroad in this case establish from the proceeds of the loans balances in London in the names of the borrowers; these balances are converted by the Americans into dollars, by drawing sterling bills against them and selling the bills in the New York exchange market.

These international loans are commonly referred to as the export and import of capital. Capital is said to be exported when Americans make investments abroad, imported when they borrow abroad. A little reflection will reveal that an export of capital is not really an *export* but an invisible *import*, and that an import of capital is not really an *import* but an invisible *export*. An export of capital involves the *importation* of securities and an increased *demand* for foreign exchange; an import of capital, the *exportation* of securities and an increased *supply* of foreign bills. An export of capital thus produces effects on the exchange market directly opposite to those produced by an export of goods.

The repayment by Americans of loans previously granted by foreigners gives rise to a demand for foreign bills, and is, therefore, analogous to an export of capital. Here, Americans import securities which they have formerly issued to foreigners. Contrariwise, the repayment by foreigners of American loans is analogous to an import of capital—there is an increase in the supply of foreign bills in the exchange market. In this case, Americans export foreign securities which they have previously purchased.

*Short-Term Capital Movements.* Short-term international movements of capital have the same effects upon the foreign exchange market as long-term capital movements: an outward flow of short-term capital causes an increase in the demand for foreign bills of exchange, an inflow, an increase in the supply of bills. Short-term capital movements differ from long-term loans, however, in respect to the causes which produce them and the forms which they take.

Investors buy stocks and bonds of foreign corporations and governments rather than domestic securities primarily because the foreign issues afford a higher yield, after allowance has been made for the risk factor. Likewise, interest-rate differentials among the various money markets induce holders of funds available for short-term investment to shift them from the markets of low discount rates to those with higher rates, and encourage dealers and others

in the high interest-rate markets to borrow in the low-rate centers in order to lend at the higher rates at home. But there are two other forces which may evoke movements of short-term capital. Exchange rates fluctuate from day to day and even from hour to hour, and dealers and individuals who anticipate these rate fluctuations are able to profit by transferring short-term funds from one money market to a foreign market. If, for example, dealers become convinced that the sterling rate will fall in the not too distant future, they will borrow sterling funds in London by drawing banker's long bills on their London correspondents. These bills can then be sent to London for acceptance and discount, and bankers' sterling sight bills, drawn against the resulting balances, can be sold in New York to American importers. Such transactions absorb investment funds in London and at the same time increase the supply of funds available for investment in New York—in short, an international transfer of capital has taken place, an import of capital into the United States. If the forecasts of the dealers are fulfilled and the sterling rate does later drop, the dealers may repay their English loans by buying sterling bills at the lower rate then existing. Repayment involves an export of short-term funds. Obviously, the profitableness of such operations is also affected by the respective discount rates in the two centers, but discussion of the complications introduced by the interest factor must be postponed until the following chapter.

When a rise in the sterling rate is expected, New York bankers may arrange for their London correspondents to draw on them bankers' long dollar bills, which will be accepted and discounted in New York. At maturity the London banks may repay the New York accepting banks by permitting the latter to draw bankers' sight bills on them. These can be sold, if the rate has actually risen in the meantime, at a price which will yield a profit on the whole transaction. The profit will be split between the New York and London banks. Speculators can also profit from an anticipated rise in the sterling rate by buying sight sterling, building up their sterling balances in London, and holding these balances until they can be sold at a higher sterling rate.

Finally, threats to the stability of a country's currency may provoke a flight of capital. Holders of liquid funds will remove them to a safer haven by purchasing bankers' sight drafts and establishing

## 56 International Trade and Commercial Policy

deposits in foreign banks or investing in bills or short-term securities abroad. It was a panicky flight of capital of this sort combined with the withdrawal by foreign bankers of their London balances in gold in an attempt to protect their reserves which forced England off the gold standard in 1931, and which earlier compelled other nations to adopt rigid systems of foreign exchange control.

International flows of short-term capital may assume divers forms, the most important of which are indicated in the accompanying tabulation:<sup>10</sup>

An inflow of short-term capital will be reflected in one, several, or all of the following ways:	An outflow of short-term capital will be reflected in one, several, or all of the following ways:
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By an increase in:	<table border="0"> <tr> <td style="font-size: 3em; vertical-align: middle;">{</td> <td style="padding: 0 10px;">                 Domestic bank deposits for foreign account.                  Holdings of bills for foreign account.                  Holdings of short-term government securities for foreign account.                  Borrowings from foreign banks.                  Acceptances made by foreign banks for domestic account.             </td> <td style="font-size: 3em; vertical-align: middle;">}</td> </tr> </table>	{	Domestic bank deposits for foreign account. Holdings of bills for foreign account. Holdings of short-term government securities for foreign account. Borrowings from foreign banks. Acceptances made by foreign banks for domestic account.	}	By a reduction in:
{	Domestic bank deposits for foreign account. Holdings of bills for foreign account. Holdings of short-term government securities for foreign account. Borrowings from foreign banks. Acceptances made by foreign banks for domestic account.	}			
By a reduction in:	<table border="0"> <tr> <td style="font-size: 3em; vertical-align: middle;">{</td> <td style="padding: 0 10px;">                 Bank deposits of domestic banks and individuals abroad.                  Loans to foreign banks.                  Acceptances made by domestic banks for foreign account.                  Broker's debit balances for foreigners.             </td> <td style="font-size: 3em; vertical-align: middle;">}</td> </tr> </table>	{	Bank deposits of domestic banks and individuals abroad. Loans to foreign banks. Acceptances made by domestic banks for foreign account. Broker's debit balances for foreigners.	}	By an increase in:
{	Bank deposits of domestic banks and individuals abroad. Loans to foreign banks. Acceptances made by domestic banks for foreign account. Broker's debit balances for foreigners.	}			

### THE BALANCE OF INTERNATIONAL PAYMENTS

A comprehensive statement that shows all the sources of supply of foreign bills of exchange and all the sources of demand for foreign bills, over a definite period of time, can be drawn up for any country. Such a statement is known as a "balance of international payments," and obviously covers all the inward and outward payments to be made across a nation's boundaries. A balance of payments may be drawn up for any period, but the period most commonly used is the calendar year. Table 3, which was prepared by the Department of

<sup>10</sup> See U.S. Dept. of Commerce, *The Balance of International Payments of the United States in 1940*, p. 74.

Commerce, shows the balance of international payments of the United States for the years 1939 and 1940. The credit column of a balance of payments should contain all cash claims of Americans against foreigners that were actually honored during the year, while the debit column should contain the corresponding cash claims of foreigners against Americans that were honored during the year.

The balance of international payments must, from its very nature, balance; i.e., the sum of the credits must equal the sum of the debits. In this respect, it resembles the balance sheet of a business firm.<sup>11</sup> But the logic of balance will be more readily grasped in the balance sheet than in the balance of payments. Clearly, the debits and credits of the business firm must balance, because two ledger entries, one offsetting the other, are made for every transaction completed by the enterprise. Although the matching of debits and credits is not so immediately apparent in the balance of payments as it is in the balance sheet, such a matching is every bit as logical and is actually as immediate.

In our earlier illustration of an export of American wheat to the value of £1000, it was assumed that importers had imported goods of an equivalent value. Now there is no reason to expect that importers of goods or services, or exporters of long-term capital, will require an equal amount of foreign exchange in the period under discussion. It may well be that during any given year not only will merchandise exports exceed merchandise imports, but all export items on merchandise, service, and long-term capital accounts together will exceed the same import accounts, or vice versa. A more careful scrutiny of the balance of payments, however, will reveal that even in this situation the balance of payments must balance, i.e., foreign credits must match foreign debits. For if the total volume of these export transactions exceeds that of import transactions, domestic exchange dealers will be unable to sell the entire foreign bank balances built up from the purchase of export bills, and their foreign balances will consequently rise. But this rise in bankers' foreign balances is an export of short-term capital, and

<sup>11</sup> This is the only respect, however, in which it resembles the balance sheet of a business firm. The business balance sheet shows the *assets, liabilities, and net worth* of a firm *at a point of time*; the balance of payments, on the other hand, shows the *international transactions* of a nation *over a period of time*.

TABLE 3. Balance of International Payments of the United States, 1939-1940

	1939 (revised)			1940		
	Receipts from Foreigners for "Imports" (Credits)	Payments to Foreigners for "Imports" (Debits)	Net Credits (+) or Debits (-)	Receipts from Foreigners for "Exports" (Credits)	Payments to Foreigners for "Imports" (Debits)	Net Credits (+) or Debits (-)
<b>Trade and Service Items:</b>						
Merchandise	3177	2318	+859	4021	2625	+1896
Merchandise Adjustments	67	44	+23	68	44	+24
Freight and Shipping	121	249	-128	186	259	-73
Travel Expenditures	149	358	-209	93	223	-130
Personal Remittances	45	144	-99	35	118	-83
Institutional Contributions		43	-43		54	-54
Interest and Dividends	546	226	+320	525	195	+330
Government Transactions	44	99	-55	32	123	-91
Miscellaneous Services	154	66	+88	89	63	+26
<b>Total Trade and Service Items</b>	<b>4803</b>	<b>3547</b>	<b>+756</b>	<b>5049</b>	<b>3704</b>	<b>+1345</b>
<b>Gold and Silver:</b>						
Gold Exports and Imports	1	3575	-3574	5	4749	-4744
Gold Earmarking Operations (net)			+534			+645
Gold Movements (net)			-3040			-4099
Silver Exports and Imports	14	85	-71	4	59	-55
<b>Total Gold and Silver Movements (net)</b>			<b>-3111</b>			<b>-4154</b>

TABLE 3. Balance of International Payments of the United States, 1939-1940 (Continued)

	1939 (revised)			1940		
	Receipts from Foreigners for "Imports" (Credits)	Payments to Foreigners for "Imports" (Debits)	Net Credits (+) or Debits (-)	Receipts from Foreigners for "Exports" (Credits)	Payments to Foreigners for "Imports" (Debits)	Net Credits (+) or Debits (-)
Capital Items (net): <sup>a</sup>						
Long-Term Capital Movements			+3			-39
Movement of Short-Term Banking Funds			+1159			+867
Special Transactions of Belligerent Governments			+69			+630
Miscellaneous Capital Items			+117			-1
Paper-Currency Movements						+35
Total Capital Items			+1348			+1492
Other Transactions and Residual <sup>b</sup>			+1007			+1317

Source: *The Balance of International Payments of the United States in 1940*, U.S. Department of Commerce, Bureau of Foreign and Domestic Commerce.

<sup>a</sup>The dollar values given include only items that can be identified and measured with reasonable accuracy. Capital items are viewed as "exports" and "imports" of exchanges of indebtedness requiring the passing of some monetary consideration.

<sup>b</sup>The residual item consists primarily of unrecorded capital transactions, although it may also include errors and omissions in other transactions.

## 60 International Trade and Commercial Policy

appears in the balance of payments as an invisible import. The increase in bankers' foreign balances will just equal the difference between total exports and total imports, exclusive of short-term capital flow, and hence will bring the balance of payments into balance. If bankers do not choose to build up their foreign balances, they may import gold. In this case, the import of gold will balance the international accounts. Since short-term capital movements and gold are integral parts of the international accounts, the balance of international payments must always be in balance for any given period of time.<sup>12</sup> A surplus or deficit in a country's merchandise, service, and investment accounts will always be balanced by movements of short-term capital or gold.

The actual compilation of a balance of payments offers certain problems. For example, when a foreign government floats bonds in the United States and merely builds up a dollar deposit balance with the proceeds, no international payment is made. However, if the balance of payments is to include the balance of short-term indebtedness, as it must, the transaction should appear in the international accounts as an export of long-term capital and an import of short-term capital. Again, a shipment of equipment by an American corporation to establish a branch plant abroad involves no international payment. But, since the export of goods appears in the export statistics, this must be offset by treating the transaction as an export of long-term capital, of the direct investment variety; the export of capital is, of course, an invisible import.

### BALANCE OF TRADE AND BALANCE OF PAYMENTS

The mercantilist terms "favorable" and "unfavorable" are still used to describe the balance of trade, although economists are trying to avoid the use of these terms by using the terms "active" and "passive." A "favorable balance of trade" (active balance) refers to an excess of merchandise exports over merchandise imports, an "unfavorable balance of trade" (passive balance) to an excess of merchandise imports over merchandise exports. Clearly, the terms

<sup>12</sup> If exporters sell on open account, the amount of these sales left unsettled at the end of the accounting period should appear in the balance of payments as a commercial loan extended to foreigners; foreign buyers have secured short-term loans from domestic sellers.

“favorable” and “unfavorable” have meaning only if applied to the balance of trade. Applied to the balance of payments, they are meaningless, for when all the international accounts are considered, there is no residue of credits over debits or debits over credits—total debits equal total credits.

Even when applied to the balance of trade, the terms are unfortunate. For they connote an evaluation of gold which the facts of modern life fail to support, as we have shown in the preceding chapter. Furthermore, a favorable balance will not necessarily attract gold to a country, because the excess of merchandise imports is generally merely a means of paying for invisible imports. Gold and short-term capital movements are, it is true, the media for effecting an equilibrium in the balance of payments, but normally neither will continue to move in one direction for long.<sup>13</sup>

The relationship between the merchandise balance and the invisible items is well illustrated by the different economic stages through which a growing nation passes. In the first stage, when a nation is young and undeveloped, it will borrow heavily from abroad, and these capital imports will be balanced by an import balance of trade (an excess of merchandise imports over exports). In the second stage, interest payments and amortization payments on the principal will exceed new borrowings abroad; to provide the foreign exchange to meet these debt service payments it will be necessary to develop an export trade balance. Eventually, the nation may reach the third stage, in which she will be lending sums in excess of the amount needed for the interest and amortization payments on her own debt; again, this situation necessitates an export trade balance. Finally, in the fourth stage, receipts for interest and principal repayments will exceed new foreign lending, and the nation will develop an import balance of trade.

The balances of payments of Great Britain and the United States afford excellent illustrations of the effects of a changing investment

<sup>13</sup> The one exception is a gold-producing country, for which gold will be a normal and regular export, e.g., the Union of South Africa. In times of political disturbance and currency instability, it is true, a flight of capital may be persistent, but such a movement of short-term capital is limited by a nation's ability to export and by the size of its gold reserves, plus the willingness of foreign speculators to buy the country's currency—a most unreliable and evanescent support.



## 62 International Trade and Commercial Policy

position and of other invisible items upon the balance of trade. During the nineteenth century up to about 1853, British exports regularly exceeded imports; in this period Englishmen were investing heavily abroad. After 1853, however, the situation was reversed, imports exceeded exports (to 1914). A growing stream of payments of interest and repayments of principal was setting in toward the lending country, and, at the same time, earnings of the British merchant marine were growing larger as the advent of iron ships propelled by steam gave the British merchant marine a new lease on life and enabled British ships to outstrip rival carriers.

The year 1873 marks a similar turning point in the balance of trade of the United States. From the beginning of the century up to that year, American imports exceeded exports, except for occasional years. This was due, in the main, to the fact that the country was in the first stage of her economic development and was a heavy borrower abroad. Other factors also contributed to the import excess, chief among which were the earnings of the American merchant marine. After 1873 exports regularly exceeded imports, except in certain years between 1873 and 1893. The country was then in the second stage; annual interest payments on the foreign debt exceeded new borrowing. The excess of merchandise exports was accentuated after 1896 by the increased travel of Americans in foreign lands and by remittances made to the old country by newly arrived immigrants in the United States. By the 1920's the United States had reached the third stage. A huge excess of exports was made possible by heavy purchases of foreign securities. If the United States is to ultimately enter into the fourth stage, in which it collects interest on its foreign loans and receives repayment of the principal, the popular belief that an excess of imports is "unfavorable" must be abandoned.

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## *Foreign Exchange: Rates of Exchange*

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One of the principal tasks of the foreign exchange market is, as we have seen in the preceding chapter, the conversion of the currency of one nation into that of another. This conversion of one currency into another is consummated through the purchase or sale in the domestic market of foreign bills of exchange, which give the owners command over foreign currencies in foreign centers. The prices at which these foreign bills are bought and sold in any country are referred to as "foreign exchange rates." In New York, the rate of sterling exchange means merely the number of dollars per pound sterling at which a bill payable in pounds in England is traded; the rate of franc exchange is merely the number of cents per franc which a bill payable in francs in France commands. The current rate for bankers' sight sterling bills may be, for example, \$4.03, that for francs \$0.0083.

Actually, there are traded in a single market at a given time many different types of bills payable in the same foreign currency, each type of which brings its own special rate. The "base" rate for a given foreign currency is that for bankers' sight, or demand, bills, and the rates for other types of bills are calculated in relation to this base rate.<sup>1</sup> The highest rate in the market is that for cable transfers. The cable rate is slightly higher than the base (demand) rate because the cable transfer will be deducted from the banker's foreign balance sooner after sale than the sight draft. The premium charged for the cable transfer is an interest charge covering the period from the date when the cable is deducted from the banker's foreign balance to the later date when a sight draft would have been de-

<sup>1</sup> There has been a tendency in recent years to regard the rate on cable transfers as the "base" rate.

ducted. Bankers' long bills sell at rates lower than bankers' sight bills, and the discount from the base rate varies with the usance; for example, 30-day bills bring a higher price than 60-day bills, and 60-day bills a higher rate than 90-day bills. The lower rates on the longer maturities are the result, again, of the interest factor: an obligation payable at some future date is today not worth its face value, and the discount from face value depends upon both the period to run to maturity and the interest rate. Rates on commercial bills are lower than those on bankers' bills of similar maturities, for the credit standing of business houses is not so high as that of banks. Furthermore, the rates on commercial bills themselves vary according to the credit ratings of drawer and drawee. As in the case of bankers' bills, the rates on commercial bills also vary with the usance. Since the rates for all types of bills payable in any one foreign currency are based upon the rate for bankers' sight bills, they all tend to rise and fall together. Changes in the interest rate will, of course, cause slight variations in the spread between the different types of bills.

#### DETERMINATION OF EXCHANGE RATES

The rate for a particular foreign currency, like any price, is the resultant of the operation of supply and demand. The equilibrium rate is that at which the volume of bills offered by sellers equals the volume demanded by purchasers. If, at a given rate, the amount of exchange wanted exceeds the amount offered (due to imperfections in the market, an increase in demand, or a decrease in supply), the competition of buyers will force the rate up. This bidding-up of the rate will reduce the amount which buyers will buy and at the same time cause the stock on the market to increase, until a new rate is reached at which the amount wanted and the amount offered are equal. Contrariwise, if at a given rate the stock on the market exceeds the amount taken (due to imperfections of the market, a decrease in demand, or an increase in supply), the competition of sellers will force the rate down. This lowering of the rate will induce buyers to increase their purchases and at the same time cause offerings to shrink, until a new rate is attained at which the amount taken equals the amount offered. Since the balance of payments includes all the items of demand for and supply of foreign bills, at an equi-

## 66 International Trade and Commercial Policy

librium rate of exchange the balance of payments is in balance—supply equals demand (the stock on the market equals the amount taken).

While the items of the balance of payments are determined primarily by forces independent of variations in the rate of exchange, they are nevertheless partially dependent upon rate variations, for both the demand for and the supply of bills possess a certain degree of elasticity, i.e., changes in the rate will alter both. A rise in the rate of exchange may reduce the amount which buyers will require in several ways. Imports will diminish, since they become, in effect, more expensive when the rate is higher. Some importers, who anticipate that the rate will fall again before long, may be able to postpone for a while their purchases of foreign bills. Purchases of foreign securities will be retarded. And the export of short-term capital may well appear to be less profitable.<sup>2</sup> On the other hand, the rise in the rate may call forth a larger supply of bills from several different sources. Since the higher rate for foreign currencies amounts to a reduction in the prices of domestic goods to foreigners, exports will increase. Exporters may also be encouraged in some instances to draw their export bills earlier than they ordinarily would. Since securities on domestic markets become cheaper for foreigners when the rate rises, they will increase their purchases of domestic securities. And short-term capital will flow into the country.<sup>3</sup> A decline in the rate of exchange, on the other hand, will induce purchasers to buy more exchange and cause a shrinkage in the stock offered, affecting specific demand-and-supply items in a way just the opposite from a rise in the rate.

These equilibrating responses of the demand-supply items in the balance of payments to variations in the rate of exchange have been called "automatic correctives." How great the variation in the rate must be, before equilibrium in the balance of payments is reestablished, depends upon two factors: the strength of these automatic correctives, i.e., the degree of elasticity of demand and supply, and the magnitude and persistence of the disturbing forces. The rate

<sup>2</sup> If it is widely believed that the rate may continue to rise, the outflow of short-term capital will actually *increase*. These correctives of the exchange rate will be more fully discussed in Ch. VIII.

<sup>3</sup> The short-term capital-flow will be outward if the consensus of opinion is that the rate will move even higher.

variation will obviously be greater when demand and supply are relatively inelastic and the disturbing forces great and persistent than under the opposite conditions.

### RATE VARIATIONS UNDER THE GOLD STANDARD

Under the gold standard, variations in the rates of exchange are confined within narrow limits. This comparative stability of exchange rates is highly favorable to the development of international trade and the granting of international loans, and is the chief merit of the international gold standard. While the discussion of an international monetary standard must be postponed to a later chapter, it is appropriate here to examine the operations of the foreign exchanges under the gold standard since the gold standard has in the past played such an important part in world trade and may in some form continue to do so in the future.

*The Gold Standard.* The essence of the gold standard is two-fold: (1) the monetary unit of the country (any country) is defined as a certain weight of fine or standard gold, and (2) the value of the monetary unit is kept equal to that of the defined weight of gold. Before the devaluation of January, 1934, the United States dollar was defined as 23.22 grains of pure gold, or 25.8 grains of gold  $\frac{9}{10}$  fine; the devaluation redefined the dollar as 13.71 grains of fine gold, or  $15\frac{5}{21}$  grains of gold  $\frac{9}{10}$  fine. Likewise, the English pound sterling was defined as 113.0016 grains of pure gold (the Bank of England's lawful selling price), or 123.27447 grains of gold  $1\frac{1}{2}$  fine.<sup>4</sup>

The value of the monetary unit (the dollar in the United States) is kept equal (under the gold standard) to 23.22 grains of pure gold through the two devices of free coinage and freedom to convert all forms of money into gold at the mint price. The right of free coinage entitles any holder of gold bullion to have it coined into standard coins at the mint price without any quantitative limit. Under a more recent form of the gold standard, the gold bullion standard, under which gold coins do not circulate, virtually the same results are obtained by permitting holders of gold to sell gold to the treasury or central bank at the mint price without limit. Since any holder of

<sup>4</sup>The Bank's selling price was £3 17s 10½d per ounce, its buying price £3 17s 9d per ounce.

## 68 International Trade and Commercial Policy

gold in the United States could sell it to the government prior to March, 1933, at \$20.67 an ounce (the price of an ounce of gold at 23.22 grains to the dollar is equivalent to \$20.67), nobody would sell it at a lower price, and consequently the price could not fall below the mint price. And, since purchasers of gold could acquire it from the government at \$20.67 an ounce through the conversion of other forms of money, nobody would pay a higher price for it, and the price could not rise above the mint price. Free coinage and conversion thus tend to keep the value of gold and the value of the monetary unit equal.<sup>5</sup> The gold standard also implies the right to melt down gold coin into bullion and the right freely to import and export either coin or bullion.

The gold standard does not demand that gold coins actually circulate, or even that gold be coined. In recent decades there has been virtually no circulation of gold coins in the United States, even while the nation was on the gold standard, because the people preferred paper money and bank deposits to gold. And under the gold bullion standard gold is not coined. All that is necessary for the complete operation of the gold standard is the free and unlimited purchase of gold by the government at the mint price and conversion of all forms of money into gold at the mint price by the government.

*Par of Exchange.* When two countries are on the gold standard, gold constitutes a common element in their currency systems and thus a link between the two currencies. Although the coins, paper money, and bank deposits of one of the countries do not circulate in the other, the gold coins of the one are acceptable by weight by the government of the other at the latter's mint price in exchange for either domestic gold coins or paper money. A definite ratio between the two monetary units thus exists by virtue of the definition of each monetary unit as a specified weight of fine gold. This ratio between the fine gold contents of the two monetary units is known as the "par of exchange." In 1930, when both the United States and Great Britain were on the gold standard, the dollar was defined as 23.22 grains of fine gold, while the pound sterling, at the lawful selling price of gold of £3 17s. 10½d. per ounce, had a gold content of 113.0016

<sup>5</sup> If the government makes a slight charge for the coinage of gold, as is frequently the case, the value of coin will tend to exceed the value of gold by the amount of this charge.

grains. The par of exchange between the two currencies was therefore \$4.86656—par of exchange =  $\frac{\text{pure gold content of } \pounds}{\text{pure gold content of } \$} = \frac{113.0016}{23.22} = 4.86656$ . The par of exchange between any two currencies can be calculated in the same way.

*The Gold Points.* The significance of the gold standard for foreign exchange is that gold affords a medium in which international payments may be made; the significance of the par of exchange is that it sets a point about which the rate of exchange fluctuates within narrow limits. An American who must make a payment of £1000 in England can secure (under the mint price of 1930) for \$4866.56 gold from the United States mint for which the Bank of England will pay £1000 in Bank of England notes, currency acceptable by his English creditor. This does not mean, however, that the American can discharge his English debt for only \$4866.56. Although it is true that for that sum he can acquire *in the United States* a quantity of gold which, when converted into pounds sterling *in England*, will supply the £1000 necessary to liquidate his obligation, in order to liquidate his obligation he must ship the gold to England. And this involves some expense. The gold must be properly crated, carted to the ship in this country and from the ship in England, and shipping services must be purchased to transport it. It must also be insured while in transit, and there will, in addition, be some loss of interest for the period during which the shipper is deprived of the use of his funds. If it be assumed that all these expenses total \$20, then the *total* cost of obtaining the £1000 in England is not \$4866.56, but \$4866.56 *plus* the \$20 shipping expenses, or \$4886.56. This is at the rate of \$4.887 per pound sterling. This rate is known as the “gold export point.” If the rate for sterling bills should rise above the gold export point, foreign remittances could be made more cheaply by shipping gold than by buying bills, and consequently gold would flow out of the country. The gold export point, therefore, sets an effective ceiling to any rise in foreign exchange rates, for remittances will always be made in the cheapest medium.

There is also a gold import point that corresponds to the gold export point. Holders of foreign bills may sell them, or send them



## 70 International Trade and Commercial Policy

abroad for encashment and conversion into gold, and this, in turn, may be imported and sold to the mint at the mint price. But, just as the export of gold involves certain costs, so does the import of gold. The holder of a £1000 sterling sight bill may convert this in London into a quantity of gold for which the United States mint will pay \$4866.56. After the payment of shipping costs to the United States, however, (assuming them to be equal to the costs of exporting gold, i.e., \$20) only \$4846.56 will be realized, a rate of \$4.847 per pound sterling. This is the gold import point. The rate on foreign bills cannot fall below this point, for at any lower rate holders of bills will prefer to import gold rather than to sell their bills. While these gold, or specie, points set effective limits to fluctuations in foreign exchange rates, gold will not ordinarily be imported or exported until the rate reaches the specie point, because, until it reaches this point, it will be more advantageous for exporters to sell their bills and for importers to buy bills.

Actually, gold is imported and exported only by dealers. Importers and exporters would ordinarily have such small shipments of gold to make that shipping costs would be prohibitive. Dealers, on the other hand, can make gold shipments in quantities large enough to realize the lowest shipping costs. The competition between dealers, however, tends to keep rates within the specie points as effectively as if commercial concerns found it profitable to make gold shipments themselves.

The gold points are not static year after year. Since they are based upon the par of exchange and the costs of shipping gold, anything that changes the par or the costs of gold shipment will tend to alter the specie points. The par of exchange rarely changes, as it is affected only by legislative act in either country which redefines the monetary unit. The gold content of the American dollar, for example, was unchanged from 1837 to 1934. Shipping costs, however, are much more variable. Improvements in transportation which shorten the time of transit, variations in interest rates, and alterations in insurance premiums, all affect the specie points. The sharp advances necessary in insurance premiums in wartime may cause considerable spread in the specie points, but in normal times they alter but little. Furthermore, since the shipping charges are ordinarily but a small fraction of the currency unit, the range between the gold points is

very narrow, and the fluctuations in exchange rates are consequently restricted.

In normal times exchange rates, in fact, rarely reach the specie points, owing to the stabilizing effects of short-term capital movements. The American exchange market before the war furnishes a good illustration of the stabilizing effects upon exchange rates of movements of short-term capital. In the fall of the year, heavy exports of agricultural products tended to force down exchange rates in New York. As rates approached the specie-importing point, foreign exchange dealers would enter the market as buyers of exporters' bills and build up their foreign balances. Two considerations impelled them to such action. First, since rates were already close to the gold import point, they could not fall much farther; and the chances were high that any changes in rates would be upward, so that their foreign balances might be disposed of later at a profit. Second, experience had taught them that, in the spring of the year, the supply of bills would be short relative to the demand and that rates would as a result be high. When the shortage of export bills developed in the spring, bankers would dispose of their excess foreign balances by selling sight bills at rates slightly below the gold export point. Still another factor prevented the rise in rates in the spring from reaching the gold export point—the inflow of short-term loans. As rates approached the gold export point, dealers in New York found it attractive to borrow abroad by drawing long bills on their London correspondents in order to build up their London balances and to sell sight bills against these balances. In the fall when export bills became plentiful and rates fell, the dealers would repay these foreign loans by purchasing exporters' bills and discounting them in London. Thus, an export of short-term capital from this country during seasons of low foreign exchange rates and an import of short-term capital during seasons of high rates restricted rate fluctuations to a range even narrower than that set by the gold points.

#### RATE VARIATIONS UNDER INCONVERTIBLE PAPER

When a nation has abandoned the gold standard and its currency consists of paper money inconvertible into gold, the specie points no longer operate to limit variations in foreign exchange rates, for the simple reason that the government no longer converts paper

## 72 International Trade and Commercial Policy

money into gold. Two cases of rate variations under an inconvertible paper currency should be examined: that of the exchange between a gold standard country and a country with an inconvertible paper currency which places no restrictions upon the export and import of gold, and that between a gold standard country and an inconvertible paper country which restricts the export and import of gold, or that between two inconvertible paper countries.

In the case of an exchange rate between a gold standard country and a country with an inconvertible paper currency and no restriction on the import and export of gold, while the points to which exchange can rise and fall are not restricted by the same considerations as in the case of two gold standard countries, they are, nevertheless, clearly defined by the price of gold. In the gold standard country the price of gold is, of course, the mint par. In the inconvertible paper country, on the other hand, the price of gold is the price at which gold is bought and sold, like any commodity, in the open market. The price of the inconvertible currency in terms of the gold currency then rises and falls with the price of gold in the inconvertible paper country and fluctuates above and below this price by no more than the cost of shipping gold. Since, however, the demand for gold for export is, under such conditions, usually the most important element in the total demand for gold in the inconvertible paper country, the open market price of gold is itself largely determined by the supply of and demand for foreign bills of exchange. Thus, because the price of gold in the inconvertible paper country is not fixed at an unvarying mint price but is subject rather to the vicissitudes of the market, the rate of exchange between the two currencies may fluctuate widely.

Where the inconvertible paper country restricts the free export and import of gold, or where both countries have inconvertible paper currencies and restrict the free export and import of gold, exchange rates are completely divorced from any stabilizing influences of gold-flows. In such cases, there is no theoretical limit to rate fluctuations other than the operation of the automatic correctives. Where the automatic correctives fail to bring a ready equality of demand and supply, exchange rates may swing far. How far they may swing is well illustrated by the German exchanges in 1923. From a gold parity of \$0.2382 for the German mark, internal infla-

tion and a heavy excess of demand over supply in the foreign exchange market, caused chiefly by heavy reparations obligations and speculation, forced the rate of the mark down to a purely nominal value of one ten-billionth of a cent.

### ARBITRAGE

For simplicity in exposition it has been assumed in the preceding discussion that all the international economic transactions of the United States are settled through the New York and London foreign exchange markets, and foreign exchange rates have consequently been stated in terms of the dollar prices for sterling bills in New York. While these assumptions in no way destroy the validity of the conclusions reached, they do oversimplify the facts. There is in London a sterling-dollar rate that corresponds to the dollar-sterling rate in New York. Furthermore, as the United States does, in fact, do business with many different countries, its international payments are effected through many pairs of foreign exchange markets and in terms of many different currencies. The same is true of other countries. Consequently, there is a whole congeries of exchange rates throughout this system of markets: dollar-franc, franc-dollar, franc-lira, lira-mark, mark-drachma, drachma-yen, etc.

The price of a particular foreign currency in a given market, say sterling in New York, depends upon the immediate demand for and supply of sterling there. Likewise, the price of dollars in London depends upon the demand for and supply of dollars in that market. If the aforementioned demand-supply situations in the two markets are not identical at the same time, the resulting dollar-sterling rate in New York and the sterling-dollar rate in London will not be equivalent. Let us assume for the purpose of illustration that the sterling cable rate in New York is \$4.85 when the dollar cable rate in London is \$4.845. While such a discrepancy in the rates between the two markets at the same time is conceivable, it is not possible for it to persist under normal conditions, for the two rates will be brought to an equivalence by the profit-seeking activities of arbitrageurs, almost as quickly as they appear. The process by which this rate discrepancy is obliterated is called "arbitrage"; it is the simultaneous purchase and sale of foreign exchange in the two markets. The effect of arbitrage operations is to create a single international

## 74 International Trade and Commercial Policy

market for the exchange of the pound and the dollar and to establish in that market a single price.

Arbitrage transactions are carried on by two men, one located in each of the two markets, who cooperate for mutual profit, and normally take place in cables alone. With the sterling cable rate in New York momentarily at \$4.85 and the dollar cable rate in London at \$4.845, arbitrage becomes profitable. The New York dealer sells in New York £10,000 in sterling cables drawn on his London collaborator for \$48,500, and simultaneously the London dealer sells in London \$48,450 in dollar cables drawn on the New York dealer for .£10,000. The £10,000 received by the London dealer from the sale of the dollar cables provides the funds to cover the sterling cable drawn by the New York dealer, and, similarly, the \$48,500 received by the New York dealer from the sale of the sterling cables provides the funds to cover the dollar cables which the London dealer has drawn on New York, with \$50 left over. The \$50 represents the profit on the transaction, and is split between the two parties.

The effects of the arbitrage are to increase the supply of sterling in New York and thus force the sterling rate in that market down, and to increase the supply of dollars in London and thus cause a weakening of the dollar there. Arbitrage will continue to drive down the sterling rate in New York and the dollar rate in London until the two rates are brought to an identity, say \$4.8475, at which point arbitrage ceases to be profitable. The purpose of arbitrage is private profit, but its effect is to wipe out discrepancies in pairs of foreign exchange rates.

In the above case, the discrepancy in the two rates was one in which both currencies were strong and the arbitragers operated by *selling* in both markets. Where the discrepancy is the reverse, i.e., both currencies are weak, arbitragers operate by *buying* cables in both markets. Suppose that the sterling cable rate in New York is \$4.85, as in the above case, but that the dollar cable rate in London is \$4.855; sterling is thus cheap in New York and dollars are cheap in London. The New York operator will then buy sterling cables, and the London operator will buy dollar cables. The sterling acquired in New York will cover the purchase of dollars in London,

and the dollars acquired in London will cover the purchase of sterling in New York. The arbitrage forces up the sterling rate in New York and the dollar rate in London until an identical rate is reached in the two markets somewhere between \$4.85 and \$4.855, conceivably \$4.8525.

Just as it is conceivable that rates in a pair of markets might diverge momentarily, so is it conceivable that rates among three or more markets might get out of line momentarily, and for the same reason, namely, because rates in each foreign exchange market are the resultant of a separate group of demand-supply factors. In a single market, however, one foreign currency cannot for long be cheap and another dear, for arbitrage will bring them into line as readily as it brings rates between a pair of markets to an equivalence. The effect of arbitrage is to create a single international market for the exchange of all national currencies and to establish in that market a single price for each currency. Although arbitrage becomes much more complex when three or four currencies are involved than when only two are concerned, the principles and operations are similar.

To illustrate, assume that the rate for sterling cables in New York is \$4.82, the rate for sterling cables in Paris 120 francs, and the rate for franc cables in New York \$0.04. Arbitragers will quickly sense that rates between New York, Paris, and London are out of line and that they can profit from arbitrage operations. Accordingly, they will sell, say, £10,000 in New York for \$48,200, buy £10,000 in Paris for 1,200,000 francs, and buy 1,200,000 francs in New York for \$48,000. The £10,000 purchased in Paris covers the sale of the same amount of sterling in New York, the purchase of the 1,200,000 francs in New York covers the sale of a like amount of francs in Paris, and the \$48,200 received from the sale of sterling in New York pays for the 1,200,000 francs purchased there, with \$200 to spare, the profit of the arbitragers. As in the case of two-point arbitrage described above, these three-point arbitrage operations will force rates in the markets concerned to equilibrium. In New York the sterling rate will be driven down and the franc rate up, and in Paris sterling will be driven up. These operations will continue until "triangular parity" is attained, where no further profits are to be realized from arbi-

## 76 International Trade and Commercial Policy

trage. Triangular parity might be represented by the following set of rates: sterling in New York \$4.80, sterling in Paris 120 francs, francs in New York \$0.04.

Rarely do rate discrepancies of any magnitude appear, for arbitrage transactions involving large sums spring up whenever the slightest discrepancy appears, so keen is the watch kept by arbitrageurs on all markets of the world. Experts in arbitrage will put through transactions involving even four or more markets if an opportunity for profit arises. These transactions fail to bring to equilibrium quotations in the different markets at a given time only when communications are broken or hampered, or when governments impose restrictions upon the free operation of exchange markets.

### FORWARD FOREIGN EXCHANGE

Persons entering into contracts which require the purchase or sale of foreign exchange at some future date face possible losses on such transactions from fluctuations in exchange rates between the time of the signing of the contract and the purchase or sale of the foreign exchange. A United States engineering concern, for example, which enters into a contract to construct a highway in Canada, payment to be made in Canadian dollars when the project is completed six months later, may discover at the end of the six months that the rate of Canadian dollars has dropped sharply and that it is unable to realize from the sale of its Canadian receipts enough domestic currency to cover the costs of the project. Or, again, a tire manufacturer in this country who has contracted for a shipment of raw rubber from the Far East, payment to be made in a foreign currency upon the arrival of the rubber four months later, may find, when he enters the foreign exchange market later to buy foreign bills, that the price of the foreign currency has advanced beyond its rate at the time he entered into the contract to buy the rubber. If he has already contracted to sell tires at prices based upon the earlier rate of exchange, he stands to suffer a net loss on the entire transaction. The existence of a market in forward exchange, however, enables both the engineering firm and the tire manufacturer to enter into contracts for the future purchase or sale of the foreign currency which

will protect them from any loss from fluctuations in foreign exchange rates.

Before entering into a contract with the Canadian government, the engineering firm may inquire of its banker the rate at which the latter will be willing to purchase spot Canadian dollars six months hence. By entering into a contract with the banker to deliver to the banker a specified sum of Canadian dollars upon completion of the construction job six months hence and by basing its contract with the Canadian government upon this rate for future Canadian dollars quoted by the banker, the engineering firm can free itself from all risks of variation in exchange rates. Of course, the engineering firm might profit if the exchange rate rose in the interval, but it will ordinarily not care to speculate in foreign exchange. Likewise, the tire manufacturer at the time he places his order for rubber will sign a contract with his banker whereby the banker agrees to deliver to the manufacturer a specified sum of the foreign currency four months after date at a stated price. Knowing exactly what his rubber is to cost him delivered at his factory, the tire manufacturer can now contract for the future delivery of tires with the assurance that his manufacturing profit will not be wiped out by adverse movements of foreign exchange rates.

Both the engineering firm and the tire manufacturer, then, can hedge against exchange losses through contracts with bankers for the future purchase or sale of foreign currencies. By doing so, however, they merely shift the risks of exchange to the shoulders of the bankers. Can the bankers, in turn, evade the risk? They may not choose to. The banker who has contracted to deliver £10,000 sterling in six months at \$4.87 and is convinced that the spot rate at that time is likely to be no more than \$4.85 may speculate on a fall in the sterling rate and not cover his future purchase contract. If his forecast is borne out and sterling actually falls to \$4.85, he profits to the extent of \$200 (\$0.02 a pound on £10,000). The risks involved in dealing in uncovered futures are so great, however, that bankers rarely go uncovered but instead close out such transactions by providing an immediate offset to each transaction.

One way of doing this is by offsetting every sale of futures by a contract calling for the purchase of a like amount of exchange at



## 78 International Trade and Commercial Policy

the same future date, and vice versa. Offsetting contracts for the purchase or sale of futures may be made with other dealers as well as with customers. When a dealer is unable to close out a futures transaction by offsetting transactions, he must resort to transactions in spot exchange. The dealer who seeks to offset a contract for the future purchase of sterling will sell spot sterling, drawing against his foreign balance or, if his foreign balance is already down to minimum working requirements, covering his sale of spot by borrowing in London. The dealer who wishes to offset a contract for the future sale of sterling will cover himself by buying spot sterling and building up his sterling balance abroad. In the former case, the spot exchange which the dealer later purchases under his futures contract will either restore his foreign balance or provide the means to pay off his foreign loan; in the latter case, he has already acquired the spot sterling with which to make future delivery. In each case, the spot transaction exactly matches the futures transaction so that the dealer need not be concerned about the future movements of exchange rates.

What determines the price of foreign exchange in contracts calling for future purchases or sales of exchange? Since dealers offset purchases and sales of forward foreign exchange by sales and purchases of spot exchange, forward transactions compel them to shift current funds between domestic and foreign money markets. The gain or loss from holding their funds abroad rather than at home will, therefore, be determined by the respective short-term interest rates in the two markets. If the interest rate is higher abroad, dealers will be eager to transfer funds to the foreign center and will consequently be prepared to sell forward exchange at a discount from the spot rate, a discount measured by the excess earnings on their funds invested at the higher foreign rate for the period of the contract minus a commission for themselves. If the short-term interest rate is lower abroad than in the domestic market, the dealers' forward selling rate will tend to exceed the spot rate by an amount equal to the deficiency in earnings abroad plus a commission.

Dealers' purchases of forward exchange will likewise be made at a discount from spot when the interest rate is higher abroad than at home. Dealers hedge their forward purchases by spot sales. Now spot sales are conditioned upon either the possession of foreign

balances or borrowing abroad, or both. In either case, spot sales involve the shifting of funds from the high-interest foreign money market to the low-interest domestic market, with a consequent loss in interest. Dealers will therefore be willing to purchase forward exchange only at a rate sufficiently under the spot rate to offset the interest loss and afford them the customary commission; the loss in interest will thus be counterbalanced by the profit from selling spot exchange at a price higher than that paid for futures. The future delivery of the foreign currency under the forward contract will provide the funds for rebuilding the foreign balance or repaying the foreign loan. Similarly, dealers' forward purchases will be made at a premium when the interest rate is lower abroad than at home. Since spot sales under these conditions involve an interest *gain*, the result of transferring funds from the low-interest foreign market to the high-interest domestic market, dealers will be willing to pay for exchange futures a premium equivalent to the difference in interest earned minus their commission. The dealers' buying and selling rates will at any given time tend to differ by twice the amount of the commission, the selling rate of course exceeding the buying rate.<sup>6</sup>

Since dealers are both buying and selling foreign currencies forward, their buying and selling contracts made in the course of a day may cancel out. But whether they do or not is immaterial, because in practice each forward contract is covered by an offsetting spot transaction, to avoid risk. A dealer's profit for the day on his forward business consists merely of the sum of the commissions on the total of his forward transactions.

*Interest Arbitrage.* Not only do dealers offset their transactions in forward exchange by dealings in spot exchange and international transfers of capital, but they also offset international transfers of short-term capital, invoked by interest-rate differentials, by transactions in forward exchange. The forward exchange market provides the means whereby funds may be transferred from a low-

<sup>6</sup> Suppose that spot sterling is \$4.00 in New York, the interest rate in London 2 per cent and in New York 4 per cent, and the dealers' commission on 90-day bills  $\frac{1}{2}$  of 1 per cent. The buying rate for 90-day sterling futures in New York will then be \$4.015 (\$4.00 the spot rate, plus \$0.02 the gain in interest from shifting spot funds from London to New York, *minus* a commission of \$0.005), the selling rate \$4.025, (\$4.00 the spot rate, plus \$0.02 interest loss, *plus* a commission of \$0.005).

## 80 International Trade and Commercial Policy

interest money market to a high-interest money market, invested there for a period, and eventually transferred back to the former market without risk of exchange loss. Such a series of transactions is known as *interest arbitrage*. An illustration may give a clearer understanding of these hedging transactions and their effects upon the rate of forward exchange. Suppose that the money rate in London is 4 per cent and in New York 2 per cent, and that spot sterling in New York is \$4.00. The interest on \$4.00 (£1) in New York for 90 days, say, will then amount to only \$0.02, a situation favorable to the shifting of funds from New York to London since, on each \$4.00 shifted to London for 90 days, additional interest of \$0.02 can be made. Dealers who thus shift funds face the risk, however, that a decline in the sterling spot rate in New York before the expiration of the 90 days will cause an exchange loss which will more than offset the interest gain of \$0.02 on each \$4.00 invested abroad. To protect themselves against such an exchange loss, they will sell sterling 90 days forward. Whether the transfer of funds to London is worth while depends therefore upon the discount on 90-day sterling futures. As long as the discount on 90-day sterling futures is less than \$0.02 for each four dollars (i.e.  $\frac{1}{2}$  of 1 per cent), the transfer of funds will be profitable. But the very transfer of funds tends to bring the discount on forward sterling and the interest-rate differential to equality: the movement of funds from the New York market to the London market raises the interest rate in the former market and lowers it in the latter, while the purchase of spot exchange and the sale of forward exchange narrows the spread between the two in New York by raising the spot rate and lowering the forward rate. When the discount on futures in New York reaches equality with the interest-rate differential between the two centers, it will no longer pay to shift funds to London. It is by such operations that the discount (or premium, if the New York interest rate exceeds the London rate) on forward exchange is brought to equality with the interest-rate differential between the two money markets.<sup>7</sup> Where

<sup>7</sup> In calculating the discount on 90-day sterling futures an allowance must, of course, be made for the dealer's commission. With spot sterling in New York at \$4.00, with the interest rate in New York 2 per cent and in London 4 per cent, and allowing a dealer's commission of  $\frac{1}{2}$  of 1 per cent, the rate for 90-day sterling futures will diverge from the spot rate by \$0.02 minus a commission of \$0.005 on sales and plus a similar commission on purchases. The dealers' selling rate will then be \$3.985, the buying rate \$3.975.

there are no restrictions on the movement of capital between two money centers and there is no lack of confidence in the stability of the currency of the high-interest center, interest arbitrage will maintain an equality between the interest rate differential between the two markets and the spread between spot and future exchange rates.

Situations may arise in which bankers find it unnecessary to protect international transfers of capital by transactions in forward exchange. Suppose that the United States and Great Britain are both on the gold standard, that spot sterling in New York is near the gold import point, and that interest rates in London and New York make it profitable to transfer funds to London. Then there is no need for bankers to cover their capital transfers by selling forward sterling, because sterling, already close to the gold import point, cannot fall further.

*Speculation.* Our discussion thus far has shown that both mercantile concerns and bankers operate in forward exchange as a hedge and that their transactions are part of the machinery of forward rate determination. Forward exchange is also used for another purpose, namely, speculation. Speculation at times exerts a strong influence upon the forward exchange market. Speculators, unlike foreign traders and foreign exchange dealers, do not employ the forward market to cover spot transactions. The very essence of speculation is the assumption of an uncovered position in the hope of profiting from favorable fluctuations in prices. If, for example, speculators in New York expect that lira exchange will be cheaper in the not too far distant future, they sell lira exchange forward, hoping that they will be able to cover these sales by purchases of spot lire 30, 60, or 90 days later at an even lower rate. If, on the other hand, they expect the lira rate to rise, they buy lira futures in the hope that they may be able to dispose of them at a higher rate later on. When there is a strong consensus that a particular currency is about to become weak, speculative forward selling may drive the forward rate to a considerable discount. For example, in 1936 immediately prior to the devaluation of the French franc, the franc sold in New York at a discount of 2 or 3 per cent *per diem*, which is on the basis of over 1000 per cent per annum. This, of course, is unusual, but for longer periods the discount was as high as 50 to 60 per cent per annum, and in 1935 the discount on Dutch guilders reached 22 per cent and that on Swiss francs 29 per cent.

## 82 *International Trade and Commercial Policy*

The reason why the discount on forward exchange rates may at times greatly exceed the interest-rate differential between the markets concerned is that forward rates always reflect political and economic disturbances. When a country faces serious political and economic disturbances, the government usually imposes exchange regulations which prohibit the export of capital as well as loans and overdrafts to foreigners.<sup>8</sup> As the belief becomes widely held abroad that drastic changes in the currency laws of the country, such as devaluation or abandonment of the gold standard, are impending, speculation against the currency sets in. This speculation usually takes the form of forward sales of the currency in foreign markets, as more exporters than usual there seek to hedge by selling exchange for forward delivery, and professional speculators enter the lists against the currency. The enlarged offerings of forward exchange drive down the rate as the supply offered comes to exceed the amount which buyers will take. But the decline in the forward rate below the spot rate is not, under these conditions, limited to the equivalent of the interest-rate differential; it may continue to levels far below that. Since bankers can neither draw freely against their balances nor borrow in the country under pressure, because of the exchange restrictions, they find it difficult to cover purchases of forward exchange by sales of spot. They are, therefore, reluctant to buy forward, as they do not care to take an uncovered position in a currency of such uncertain future. Forward buying is consequently limited largely to importers and to counter-speculators who may feel that the decline in the forward rate has gone too far.

Heavy speculation against a currency in the forward market affects the spot rate as well as the forward rate. As waning confidence in the future of a foreign currency calls forth increased forward selling, the volume of forward sales will exceed that of forward purchases, and the forward rate will decline. But, since dealers cover their forward purchases by spot sales, increased *forward* selling will be matched by increased *spot* selling, so that the supply of spot will exceed the demand, and the rate will decline along with the forward rate. So long as a country remains on the gold standard, the spot rate for its currency will, obviously, not de-

<sup>8</sup> For advice on this point I am indebted to Messrs. George B. Roberts and L. N. Shaw of the National City Bank of New York.

cline below the gold import point. Furthermore, the decline in the forward rate will not generate a corresponding decline in the spot rate, if the country under pressure imposes exchange restrictions, because bankers will be unable either to draw freely against their balances or borrow in the country imposing such restrictions.

*Conclusion.* From the foregoing discussion, it is obvious that the existence of a market in forward exchange rests upon two conditions: the absence of restrictions on international short-term capital movements, and a reasonable degree of freedom in foreign exchange trading. The international gold standard is not essential to a forward market, nor are stable exchanges. The fear that government control may prevent completion of contracts, however, deters forward trading. At times, governments explicitly prohibit transactions in forward exchange. Forward exchange markets rarely exist in currencies in which dealings are small and irregular, or in those which are pegged to a stronger currency.

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*The Case for Free Trade: The  
Modern Classical Theory of  
International Trade*

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THE INTERNATIONAL DIVISION OF LABOR

During the past century and a half, the restrictive protectionism of mercantilism has pretty much dominated the commercial policy of most nations, although it has manifested greater virility in some periods than in others and has been carried to greater extremes by some nations than by others. Furthermore, in every nation, even in free trade England of the pre-World War era, the doctrine of protection has found champions in specific economic and social groups. But protection has encountered a worthy opponent in the doctrine of free trade. The strength of the free trade doctrine lies in its ability to demonstrate that the unrestricted international exchange of goods increases the real income of all the participating countries. This maximization of the social product under free trade rests essentially upon the inherent advantages of specialization (the division of labor).

The gains resulting from the specialization of human labor have been briefly indicated in Chapter I. A somewhat fuller treatment of the subject appears desirable here. First, specialization enables individuals who devote themselves to one job to develop a superior skill in that job, with a resultant community product that is superior in both quality and quantity. The professional printer, automobile mechanic, or physician will not only do a much better job than the jack-of-all-trades, but will also do it with greater facility. Second,

specialization permits those with special talents to work at those tasks for which such talents are especially valuable. The man with great executive ability can manage a big business organization, and need not waste his talent operating a machine, keeping accounts, or polishing his own shoes. Third, the division of labor results in a considerable saving of time, time which must be lost if individuals have to pass from one job to another, hour by hour. The division of labor also facilitates the invention and use of machinery. The man who spends all his time on one job and who becomes complete master of this job will be more likely to suggest constructive changes in the technique and tools connected with the job than the man who is engaged at such a task only occasionally. If the division of labor is carried far enough, large-scale production results, and it is possible for the business unit to support a research corps whose sole task is the improvement of the mechanical processes. Research staffs are today integral parts of the automobile, chemical, electrical equipment, and petroleum industries, to mention only a few. Moreover, the use of machinery splits up more complex industrial processes into simple ones, substitutes the use of steam or electric power for human power, and itself pushes further the division of labor. In addition, the very increase in the national income which accrues from the division of labor will make possible a larger volume of savings; and the larger national savings, in turn, will make possible an enlargement of the nation's capital equipment, and increase further the productivity of labor.

But the division of labor would be impossible without trade. In an economy based upon specialization, each worker is engaged in the production of only a single commodity, and frequently he performs only one simple operation in the complex process of producing a given commodity. What he directly consumes—his food, shelter, clothing, fuel, amusement, education, medical and dental services, etc.—he acquires only through exchange with other specialists. Without trade, the most skilled surgeon in the community would either starve or be forced to become a jack-of-all-trades. Exchange, to repeat, is the *sine qua non* of specialization.

Just as a given community, or nation, may increase its real income and the incomes of its individual citizens by abandoning individual self-sufficiency for individual specialization, so may the world in-



## 86 International Trade and Commercial Policy

crease its real income and the incomes of the individual nations by foregoing national self-sufficiency for national specialization. Nations, like individuals, are endowed by nature with special facilities; and nations, like individuals, acquire special skills. Minerals can be produced only in those nations where nature has stored them: nickel in Canada; tin in Bolivia, the East Indies, and the Malay States; manganese in Brazil and Russia; petroleum in the United States, certain Latin American countries, Russia, Iraq, and the Dutch East Indies. Nations not endowed by nature with stores of these minerals can acquire them only through exchange with nations more favorably endowed. Many agricultural products require for their cultivation a special climate. Coffee, tea, rubber, and silk, for example, demand a warm or tropical climate, while most of the cereal crops do much better in the cooler lands of the temperate zones. Consequently, the United States imports its coffee, tea, rubber, and silk, while tropical countries import from countries in the temperate zone most of their cereals.

The advantages to a country of specializing along the lines of its special talents have been admirably stated by Adam Smith:

The natural advantages which one country has over another in producing particular commodities are sometimes so great that it is acknowledged by all the world to be in vain to struggle against them. By means of glasses, hotbeds and hot walls very good grapes can be raised in Scotland, and very good wine, too, can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines, merely to encourage the making of claret and burgundy in Scotland? But if there would be a manifest absurdity in turning toward any employment thirty times more of the capital and industry of the country than would be necessary to purchase from foreign countries an equal quantity of the commodities wanted, there must be an absurdity, though not altogether so glaring, yet exactly of the same kind, in turning toward such employment a thirtieth, or even a three-hundredth part of either. Whether the advantages which one country has over another be natural or acquired is in this respect of no consequence. As long as the one country has those advantages, and the other wants them, it will always be more advantageous for the latter rather to buy of the former than to make. It is an acquired advantage only which one artificer has over his neighbor who exercises another trade; and yet they both find it

more advantageous to buy of one another than to make what does not belong to their particular trades.<sup>1</sup>

The productive advantages which one nation has over another may not spring from the bounties of nature, but may, as Adam Smith suggests, flow from certain acquired skills; racial qualities of manual dexterity, scientific ability, vigor and enterprise, the capacity for conducting enterprise on a large scale, or from the whole chain of historical accidents. By 1914, the German chemical industries had won a position of such preeminence that they had become the chief supplier of coal-tar dyes and drugs to the whole world. This preeminence rested largely upon an abundant supply of highly trained chemists and chemists' assistants, and the German faculty for efficient, large-scale business organization. American exports of automobiles, electric machinery, industrial and business machinery flow today from the American capacity for large-scale production and the venturesomeness of business enterprise in the United States. The large, internal, free-trade market furnished by a nation of 130 million people, too, has been exceedingly favorable to the development of large-scale production in the United States. The fine, hand-woven rugs of Persia and China are made by tribes which for centuries have cultivated the art of rugmaking; while the fine laces, silks, and papers of France are the products of artisans whose forebears for generations have been building skills in the manufacture of high-quality, luxury goods. Great Britain's long leadership in the export of a diversified list of manufactured goods—iron and steel products, ships, textiles, pottery, machinery—reflect the fact that it was England which introduced to the world the Industrial Revolution, itself the offspring of a multitude of forces: economic, financial, political, religious, and social. National productive advantages may thus rest upon acquired skills as well as upon the gifts of nature.

The essential condition of trade between nations is that the goods traded be produced more cheaply in one nation than in another, after allowance has been made for transportation costs. The obvious gain from international trade lies in the lower prices at which certain goods can be bought abroad, as compared with the prices which the same goods would have to bring if produced at home.

<sup>1</sup> *Wealth of Nations* (Collier edition), II, 163-164.

## 88 International Trade and Commercial Policy

Cheapness of price is, however, merely indicative of a more fundamental gain. Through foreign trade, goods can be obtained from a lower cost combination of the factors of production than that which domestic production would require. This truth, too, has been stated by Adam Smith in his usual forceful style:

What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. The general industry of the country, being always in proportion to the capital which employs it, will not thereby be diminished, no more than that of the above-mentioned artificers; but only left to find out the way in which it can be employed with the greatest advantage. It is certainly not employed to the greatest advantage, when it is thus directed toward an object which it can buy cheaper than it can make. The value of its annual produce is certainly more or less diminished when it is thus turned away from producing commodities evidently of more value than the commodity which it is directed to produce. According to the supposition, that commodity could be purchased from foreign countries cheaper than it can be made at home. It could therefore, have been purchased with a part only of the price of the commodities, or, what is the same thing, with a part only of the price of the commodities, which the industry employed by an equal capital would have produced at home, had it been left to follow its natural course. The industry of the country, therefore, is thus turned away from a more to a less advantageous employment, and the exchangeable value of its annual produce, instead of being increased, according to the intention of the law-giver, must necessarily be diminished by every such regulation.<sup>2</sup>

In summary, the case for free trade rests upon the advantages of the international division of labor. Just as the division of labor among individuals leads to a larger individual income, so the division of labor among nations provides each nation with more goods, better goods, and even goods which a particular nation could not produce itself. Any interference with the flow of trade between nations will diminish international specialization, and consequently reduce the advantages deriving from such specialization.

It has been objected that free trade is cosmopolitan, i.e., that

<sup>2</sup> *Ibid.*, pp. 162–163.

although a policy of free trade may maximize the *world* income, it may be detrimental to the income of a specific country. In other words, a particular nation may find that, so far as it is concerned, it will gain economically from a policy of protection rather than from one of free trade. The fallaciousness of this view will be pointed out in the following pages of this chapter. Suffice it here to remark that it is true that free trade leads to a larger world income, but it is also true that *each* and *every* nation in the world system of nations will experience a larger real income under free trade.

It should be noted, however, that this appraisal of free trade postulates a criterion for commercial policy: the maximization of the national income. Upon this postulate, the case for free trade has withstood every assault of its protectionist opponents. But protectionists, while granting the desirability of the largest possible national income, may, at the same time, consider other ends to be more important. Where trade restriction seems to be an appropriate means for attaining these ends, the sacrifice in national income which trade restriction entails may be deemed a not unreasonable price to pay. One such goal, for the achievement of which many have considered protection to be a desirable means, is the reduction of unemployment in a nation. Another is the nurturing of industries regarded as essential for military defense. Such arguments for protection will be evaluated in later chapters.

One other benefit of free trade should be mentioned. The establishment of industrial monopolies will be more difficult in a country which follows a free-trade policy than in a protectionist country. In a free-trade country, monopolistically-minded business groups will have to contend not only with potential competitors at home but with foreign competitors as well. Of course, *international* monopolies may be established, but the obstacles to the formation of such monopolies are much more formidable than those to the formation of purely national monopolies. Experience shows, moreover, that it is easier to bring a domestic industry into an international cartel when the domestic industry is monopolized than when it is made up of many competing producers. Two advantages result from the discouragement of monopoly. On the one hand, competition assures a generally lower level of prices and a consequent greater physical output than monopoly permits; and, on the other, competition stimu-

## 90 *International Trade and Commercial Policy*

lates enterprise and inventiveness, and results, in general, in a more efficient conduct of business than monopoly.

### THE THEORY OF COMPARATIVE COSTS

The direct stimulus to, and gain from, foreign trade is cheapness—the purchase of goods from abroad at a lower price than that at which they could be produced and sold at home. But we must examine carefully why particular goods can be produced more cheaply in some countries than in others, for many popular explanations of this cheapness involve glaring fallacies.

The quest of economics for a satisfactory explanation of the differing cost of producing identical goods in different countries has produced two leading theories: the doctrine of comparative costs, first formulated by Ricardo and later elaborated and refined by Mill, Marshall, Taussig, and others;<sup>3</sup> and the mutual interdependence, or general equilibrium, analysis, evolved first as a general theory of value by Walras, Pareto, and Cassel, and more recently developed into a theory of international trade by the Swedish economist, Bertil Ohlin.<sup>4</sup> This chapter and the one following are devoted to a summary of the theory of comparative costs; Chapter VII, to a summary of the mutual interdependence theory.

The formulation of the theory of comparative costs by Ricardo and the classical economists resulted from the search for answers to two questions: first, what goods a nation would find it advantageous to export, on the one hand, and what ones profitable to import, on the other; and second, on what terms the nation would exchange its exports for the goods imported from foreign countries. The solution of these two problems would, in turn, reveal the extent of the nation's gain from foreign commerce. The classicists also incorporated into their theory of international trade the price-specie-flow analysis, formulated by Hume, to explain how disequilibria in international balances of payments were corrected and the need for continuous international flows of gold or short-term capital obviated.

<sup>3</sup> Professor F. W. Taussig's *International Trade* (New York, 1927) develops the theory of comparative costs to its highest peak of refinement.

<sup>4</sup> *Interregional and International Trade*, Cambridge, 1935.

In order to understand the classical economists' formulation of the doctrine of comparative costs, it will be helpful to restate briefly the salient features of Ricardo's general theory of the exchange value of commodities. Two assumptions underlay this theory: first, that labor was completely mobile, occupationally and geographically, i.e., that labor could move freely from one occupation to another and from one place to another, within a country; and second, that the only element to be considered in the cost of production was labor. Ricardo recognized that the use of capital involved another cost in the form of interest, but he avoided the complications which this might introduce by supposing that capital and labor were always combined in production in a constant proportion. Another complicating factor, the varying rates of wages received by different grades of labor, was similarly disposed of by assuming that different grades of labor, too, were always combined in constant proportions. Given these assumptions and the existence of competition among laborers and employers, it follows that the prices of different goods will be proportional to the number of hours of labor required to produce them.<sup>5</sup>

But, although this general theory might explain the exchange values of goods within any given country, it could not possibly explain the values of goods exchanged between countries, because between countries labor does not move freely. Without international labor mobility, there can be no tendency towards the international equalization of wages. Since wage rates may differ, and differ considerably, between countries, the exchange values of goods traded between countries need not be proportionate to their cost in labor hours. For example, Country A may export shoes to Country B in exchange for rugs. If the production of a pair of shoes in Country A requires five hours of labor, and labor is remunerated at the rate of \$1.00 an hour, the price of the shoes will be \$5.00 a pair. In Country B, the manufacture of a rug may take 50 hours of labor, but if labor in that country receives only \$0.20 an hour, the price of

<sup>5</sup> In the first chapter of his *Principles of Political Economy and Taxation*, Ricardo recognizes that capital and wage differences do influence value independently of labor costs. But, elsewhere, he overlooks these qualifications, and tends to regard the number of labor hours as the sole determinant of value.

## 92 International Trade and Commercial Policy

the rug will be only \$10.00. The terms of international trade will, therefore, be two pairs of shoes for one rug, instead of ten pairs of shoes for one rug, the terms which would have held had both articles been produced within one country at the indicated labor costs. The dissimilarity between the terms of trade between the two nations and those which would exist within a single nation is due to the difference in national wage levels. Thus, Ricardo's general theory of value was obviously unsatisfactory for the explanation of values in international trade.

Because Ricardo clearly perceived the impossibility of explaining values in international trade by his general theory of value, he was compelled to develop a special theory of international values. This special theory was the theory of comparative costs.

*comparative costs* Because nations are differently equipped with natural resources, capital, human and technological skills, transportation facilities, and the like, labor costs (the number of labor hours) of producing identical goods will vary from country to country. More than this, *relative* costs of different commodities will vary from country to country. It is this variation in *ratios* of costs in different countries which makes international trade possible. The doctrine of comparative costs states that if trade is free between countries, each country tends to specialize in the production of those commodities in the production of which it enjoys a comparative advantage in terms of labor costs, and to import those commodities which could be produced at home only at a comparative disadvantage in terms of labor costs, and that specialization is to the mutual advantage of the participating countries. It should be emphasized again that *ratios* between costs must vary in different countries if international trade is to take place. This principle may best be illustrated by numerical examples.

### (1) ABSOLUTE DIFFERENCES IN COSTS

Let us consider first the trade between two countries where each country can produce one of two commodities at a labor cost lower than that of the other country. We may assume that both bananas and wheat can be produced in Guatemala and the United States, at the costs indicated below:

	Output	
	Bananas (lbs.)	Wheat (bus.)
In Guatemala 10 days' labor will produce	200	or 10
In U.S. 10 days' labor will produce	50	or 20

Guatemala can produce bananas more cheaply than the United States, and the United States can produce wheat more cheaply than Guatemala. In the absence of international trade, 200 pounds of bananas will exchange in Guatemala for 10 bushels of wheat, while in the United States the terms of exchange will be 50 pounds of bananas for 20 bushels of wheat. But obviously both nations will gain through exchange, Guatemala exporting bananas and the United States wheat. The respective costs of producing the commodities in the two countries will not in themselves determine the terms upon which wheat will be exchanged for bananas, but comparative costs will set *limits* within which the terms of trade will settle. Since 20 bushels of wheat will command in trade 50 pounds of bananas in the United States and 400 pounds of bananas in Guatemala, it will be to the advantage of the United States to export wheat if for 20 bushels of wheat she can obtain from Guatemala bananas in excess of 50 pounds. And it will be to Guatemala's advantage to export bananas if she can obtain from the United States 20 bushels of wheat for anything less than 400 pounds of bananas. Since both of these conditions are fulfilled, trade will ensue; and the terms of trade will lie somewhere between 50 pounds of bananas for 20 bushels of wheat and 400 pounds of bananas for 20 bushels of wheat.

Possible terms of trade would be 200 pounds of bananas for 20 bushels of wheat. Under these terms, the United States would obtain for wheat which cost her only 10 days' labor to produce, bananas which would have cost her 40 days of labor to produce at home. In other words, for each 10 days of labor she gains through international trade 150 pounds of bananas. But Guatemala also gains. For bananas which cost her 10 days of labor to produce, she acquires through trade wheat which, if produced at home, would have required 20 days of labor. Or, looked at from a different angle,



## 94 International Trade and Commercial Policy

for each 10 days of labor she realizes through exchange a gain of 10 bushels of wheat. Thus, each nation experiences an increase in its national income as a result of the exchange.

It has been observed above that although comparative costs in the respective countries will set the *limits* of the terms of trade, costs alone will not determine the *actual* terms of trade. The exact location of the terms of trade, within the limits set by comparative costs, will be determined by reciprocal demand, to use a term coined by John Stuart Mill; i.e., by the demands of the two countries for each other's products in terms of their own products. Trade between the two countries will be in equilibrium when the ratio of exchange between the two commodities is such that the quantity of the commodity exported by either country is just sufficient to pay for the quantity of the commodity imported by the country.

The terms of trade will be strongly influenced by the relative intensity and elasticity of the demand of each country for the products of the other. Thus, if the demand of the United States for bananas is more intense than that of Guatemala for wheat, the terms of trade will be closer to 50 pounds of bananas for 20 bushels of wheat than to 400 pounds of bananas for 20 bushels of wheat. The United States will obviously gain less from trade at a ratio of 51:20 than she will at a ratio of 400:20. Nevertheless, she will still gain from the exchange upon terms of 51:20, for she will be able to obtain her bananas at a lower labor cost than if she had to produce them at home. On the other hand, if the Guatemalan demand is the more intense, the terms of trade will settle closer to 400 pounds of bananas for 20 bushels of wheat than to 50 pounds of bananas for 20 bushels of wheat. Although Guatemala's gain will be less at the exchange ratio of 399:20 than at 51:20, it will still pay her to trade, for she will be able to obtain her wheat at a lower labor cost than that which the domestic production of wheat would involve.<sup>6</sup> Furthermore, were the American demand for bananas relatively more elastic than the Guatemalan demand for wheat, the terms would veer more to the favor of the United States, that is, closer to 400:20. For, as the value of bananas in terms of wheat tended to rise, the Americans would be more strongly deterred from buying bananas than would

<sup>6</sup> In addition to the American demand for bananas and the Guatemalan demand for wheat, the American demand for wheat and the Guatemalan demand for bananas must also be considered.

the Guatemalans from buying wheat, should the price of wheat rise in terms of bananas. In brief, the Americans would here be in a much stronger bargaining position than the Guatemalans. The opposite would, of course, be the case were the Guatemalan demand the more elastic.

International trade in modern times is not a trade of barter, however, but an exchange of goods for money. Each transaction is independent, and the purchaser buys in the cheapest market. The transition to money prices, in our illustration, may be easily made by introducing the payment of money wages, so that costs may be quoted in terms of money prices instead of labor hours. If wages in the United States are \$1.50 a day and in Guatemala \$1.00 a day, supply prices in the two countries will be:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.50	\$15.00	50 lb. bananas	\$0.30
In U.S. 10 days' labor	1.50	15.00	20 bus. wheat	0.75
In Guatemala 10 days' labor	1.00	10.00	200 lb. bananas	0.05
In Guatemala 10 days' labor	1.00	10.00	10 bus. wheat	1.00

Since bananas would cost \$0.30 a pound to produce in the United States while they can be bought for \$0.05 a pound in Guatemala, it will be to the advantage of Americans to import their bananas. Likewise, it will pay the Guatemalans to import their wheat because they can obtain it from the United States at a price of \$0.75 a bushel, whereas it would cost \$1.00 a bushel to produce it at home. The results are the same as those which flow from trade under conditions of barter: each nation gains by acquiring its imports at a lower cost than that at which they could be acquired through domestic production. And the flow of trade is the same as under barter: Guatemala exports bananas and the United States wheat.

What quantities of goods will move between the countries? By way of illustration, it may be supposed that the United States sends to Guatemala 600,000 bushels of wheat at \$0.75, total value \$450,000, and Guatemala sends to the United States 9,000,000 pounds of bananas at \$0.05, total value \$450,000. Trade is in equilibrium:

## 96 International Trade and Commercial Policy

the total value of each country's imports equals the total value of its exports. The transactions will, of course, be carried out through the foreign exchange markets, but the total offerings of bills by exporters will just match the demand for bills by importers. The rate of exchange will be close to par, and no gold will flow. The terms of trade will be one bushel of wheat for 15 pounds of bananas.

Suppose, now, that the demand of Americans for bananas increases. Money payments to be made by Americans to Guatemalans will increase and exceed those that must be made by Guatemalans to Americans, and the equilibrium of trade will be disturbed. The greater demand by Americans for means of payment abroad will cause the rate of Guatemalan exchange in New York to rise, and, assuming no sympathetic movement of short-term balances, to rise to the gold export point. Gold will flow from the United States to Guatemala. But this international movement of specie will affect prices and wages in both countries. In the United States, prices and wages will fall; in Guatemala, they will rise. The lower American prices and the larger Guatemalan incomes will induce Guatemalans to buy more American wheat, while the higher Guatemalan prices and smaller American incomes will curtail the American demand for Guatemalan bananas. Gold will continue to flow from the United States to Guatemala and to affect prices and wages in the two countries until a new international equilibrium is effected, i.e., until exports equal exports.

Assuming that the respective incomes are changed to such an extent that the Guatemalan wage rate is raised from \$1.00 to \$2.00 a day and the American rate is lowered from \$1.50 to \$1.00 a day, supply prices in each country will be altered in the following way:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.00	\$10.00	20 bus. wheat	\$0.50
In U.S. 10 days' labor	1.00	10.00	50 lb. bananas	0.20
In Guatemala 10 days' labor	2.00	20.00	10 bus. wheat	2.00
In Guatemala 10 days' labor	2.00	20.00	200 lb. bananas	0.10

The domestic supply prices of both bananas and wheat have fallen in the United States and have risen in Guatemala. However, it is

still cheaper to produce wheat in the United States and bananas in Guatemala, and consequently the course of trade will remain unchanged. But the terms of trade will alter—alter in favor of Guatemala. The new situation of equilibrium might be that the United States sends to Guatemala 2,000,000 bushels of wheat at \$0.50 a bushel, total value \$1,000,000, and Guatemala sends to the United States 10,000,000 pounds of bananas at \$0.10 a pound, total value \$1,000,000. Again the value of exports equals the value of imports, so that specie does not flow. The greater demand of Americans for bananas has resulted in an increased importation, but at a higher price. The higher price for bananas and the lower price for wheat has brought about new terms of trade—terms less favorable to the United States. Previously, the United States obtained for 1 bushel of wheat 15 pounds of bananas. Now she gets only 5 pounds.

But can it be said that the United States has lost as a result of the altered situation? The terms of trade are, to be sure, less favorable for her. She has to give up for each pound of bananas that she obtains more wheat than previously. However, this altered situation is entirely the outcome of the free choice of Americans. They wanted more bananas, and they were willing to pay the higher price necessary to obtain them. Their demands had undergone a change whereby their estimation of bananas relative to wheat rose. Despite the fact that they acquired a few more bananas by giving up a great deal of wheat, it remains that this new distribution was freely chosen; and since it was freely chosen, it must have been because it was felt that the new distribution of goods would create greater satisfaction than the old.

In the general case which has just been analyzed, the possibilities and advantages of international exchange are obvious. The United States has an absolute advantage in the production of wheat, and Guatemala has an absolute advantage in the production of bananas. This is typical of the trade between countries in the temperate zones and those in the tropics. In such trade, not only is there a possibility of clear gain. There is also a possibility of varying apportionment of this gain, the key to which lies in the respective money incomes of the people in the trading countries. In our original illustration, money incomes are higher in the United States than in Guatemala, and the American with his high money income has a position as pur-

## 98 International Trade and Commercial Policy

chaser of international goods superior to that of the Guatemalan with his lower money income. This difference in money incomes is possible only because the Guatemalans cannot move to the United States in numbers sufficient to bring about an equalization of wages in the two countries. But it is conceivable, and quite consistent with the continuance of trade, as has been illustrated above, that money incomes in Guatemala exceed those in the United States, or that money incomes in the two countries be equal.

### (2) COMPARATIVE DIFFERENCES IN COSTS

The potential gains from trade are just as real, although not so obvious, when, instead of each country's having an absolute advantage in the production of one commodity, one country has an advantage over the other in the production of *both* goods. In other words, each commodity can be produced at a lower labor cost in one country than in the other. In such a case, one condition is necessary to make trade profitable: the ratios of the costs of the two (or more) commodities must be different in the two countries.

By way of illustration, let it be assumed that:

	Cloth	or	Copper
10 days' labor in the United States will produce	20	or	20
10 days' labor in England will produce	15	or	10

Obviously, the workers of England would improve their economic status by moving en masse to the United States. By so doing, they would increase the productivity of their labor, and would consequently realize higher incomes.<sup>7</sup> The reasons why such mass migrations do not take place have already been indicated, viz., the general social, political, and economic obstructions to the free movement of the factors of production across national boundaries. But, although the English cannot improve their economic status as a people by actually working in the more bounteous industrial environment of the United States, they may, nevertheless, enjoy some of the benefits of the American industrial machine and enhance their own incomes

<sup>7</sup> This conclusion assumes conditions of constant costs. If diminishing returns were experienced, the conclusion would have to be modified. The case of diminishing returns is considered in the following chapter.

through trading with the more fortunate Americans. And, despite their greater all-round productiveness, the Americans, too, will experience enlarged incomes from this international commerce.

Since the ratio of costs in the United States is 20 cloth for 20 copper, or 10 cloth for 10 copper, and the cost ratio in England is 15 cloth for 10 copper, a mutually beneficial trade is possible in which the United States exports copper and England cloth, the United States receives for 10 copper anything in excess of 10 cloth, and England pays for the 10 copper anything short of 15 cloth. Whether the actual terms of trade settle closer to 10:10 or 15:10 will depend, as in the case discussed above, upon the relative intensities and elasticities of the demands of the two countries for each other's products. Let the terms of trade become 10 copper for 13 cloth. England's gain is apparent; she obtains copper which would have required 10 days' labor to produce in England for cloth which it takes her only 8½ days to produce. But America's gain is just as apparent; for 20 copper, which it takes her laborers 10 days to produce, she acquires 26 cloth, which would have taken her laborers 13 days to produce. At any other terms of trade between 10:10 and 15:10, each country would likewise gain from the exchange, although the division of the gain would be different. Thus, as in the case of absolute advantage, trade is possible between nations, and mutually advantageous to the nations participating in the trade, where the advantage is a comparative one. The United States, although productively superior all around, finds it to her advantage, nevertheless, to specialize in the production of, and to export, that commodity in which she has a superior advantage; while England finds it worth while to specialize in the production of, and to export, that commodity in which her *disadvantage* is less.

There is, however, one respect in which the case of comparative advantage differs from that of absolute advantage. In the case of absolute advantage, it is consistent with the continuance of trade that *either* country have a higher level of money incomes than the other, or that money incomes be at the same level in the two countries; the play of reciprocal demand will be the final determinant. Under conditions of comparative advantage, this cannot be so. The country having the greater productivity of labor must also have the higher level of money incomes.

## 100 International Trade and Commercial Policy

To illustrate, let wages in both England and the United States be one dollar a day. Then, assuming that labor productivity in the two countries is unchanged, supply prices will be:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.00	\$10.00	20 cloth	\$0.50
In U.S. 10 days' labor	1.00	10.00	20 copper	0.50
In England 10 days' labor	1.00	10.00	15 cloth	0.66 $\frac{2}{3}$
In England 10 days' labor	1.00	10.00	10 copper	1.00

Since both copper and cloth are cheaper in price in the United States than in England, both goods will be imported into England from the United States. But it will be a one-way trade—an unstable trade—wherein the importing country will be obliged to pay for its imports in gold. It has been demonstrated above, however, that the flow of gold will affect money incomes and prices in both countries, so that wages in England will fall and those in the United States rise. Wages may, for example, fall to \$0.75 in England and rise to \$1.25 in the United States, with the following results:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.25	\$12.50	20 cloth	\$0.625
In U.S. 10 days' labor	1.25	12.50	20 copper	0.625
In England 10 days' labor	0.75	7.50	15 cloth	0.50
In England 10 days' labor	0.75	7.50	10 copper	0.75

Such wages would produce conditions of a potentially stable equilibrium, for the domestic supply price of copper is now lower in the United States than in England, and that of cloth is lower in England. A two-way trade is possible in which gold-flows need play no part, since the total value of imports will equal the total value of exports. A possible international balance of trade might be:

The United States imports from England 1,000,000 cloth at \$0.50 = \$500,000  
 England imports from the United States 800,000 copper at \$0.625 = \$500,000

Wages in the United States cannot, however, exceed those in England to the full extent of the superiority which labor possesses over English labor in producing that commodity wherein its comparative advantage lies. American labor, in this illustration, is twice as effective in producing copper as English labor. But, if American labor should receive a wage twice that of the English, equivalent to its full superiority in producing copper, the resulting trade would be an unstable one. Let wages in the United States rise to \$1.40 a day and those in England fall to \$0.70 a day. Supply prices in the two countries will then be:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.40	\$14.00	20 cloth	\$0.70
In U.S. 10 days' labor	1.40	14 00	20 copper	0.70
In England 10 days' labor	0.70	7.00	15 cloth	0.46 $\frac{2}{3}$
In England 10 days' labor	0.70	7.00	10 copper	0.70

The United States will import cloth, but will have to pay for it in gold, because her supply price for copper is as great as that of England, and England will buy no American copper. The international flow of gold will narrow the wage difference of the two countries, cause the supply price of copper in the United States to fall below that of England, and bring about conditions of trade equilibrium—with the American wage level somewhat less than twice as high as the English.

### (3) EQUAL DIFFERENCES IN COSTS

It has been pointed out that a condition essential to the opening and maintenance of international trade is that ratios of costs differ between countries. The impossibility of trade when these cost ratios in different countries are equal may be easily seen from another illustration. Let the conditions of production be:

	Cloth		Copper
10 days' labor in U.S. will produce	30	or	20
10 days' labor in England will produce	15	or	10



## 102 International Trade and Commercial Policy

Despite the fact that labor is more efficient in producing both cloth and copper in the United States than in England, the ratios of cost are the same: three cloth for two copper. Obviously, there is no latitude for trade here. As in the case of comparative differences in costs, English labor would improve its condition by moving en masse to the United States. But obstacles to international movements of the productive factors rule this out.

The introduction of money wages will not alter the situation. Since labor productivity is higher in the United States, wage levels in the two countries cannot be equal. To illustrate, let us assume wages of \$1 a day in both England and the United States:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.00	\$10.00	30 cloth	\$0.33 $\frac{1}{3}$
In U.S. 10 days' labor	1.00	10.00	20 copper	0.50
In England 10 days' labor	1.00	10.00	15 cloth	0.66 $\frac{2}{3}$
In England 10 days' labor	1.00	10.00	10 copper	1.00

The result of equal wages in England and the United States when labor productivity in the United States is higher in all lines would be a one-direction trade, with the United States alone exporting. The resultant loss of gold by England and gain by the United States would raise incomes and prices in the latter, and lower them in the former. Price and income equilibrium would result only when wages in the United States were double those in England, as indicated by the table below:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.50	\$15.00	30 cloth	\$0.50
In U.S. 10 days' labor	1.50	15.00	20 copper	0.75
In England 10 days' labor	0.75	7.50	15 cloth	0.50
In England 10 days' labor	0.75	7.50	10 copper	0.75

But, with American wages double those of England, domestic supply prices in the two countries are identical. Clearly, there is no ground here for international trade.

**WAGE LEVELS, PRICES, AND COMPETITIVE ABILITY**

One of the most popular economic fallacies is that free trade will permit low-wage countries to undersell high-wage countries and will eventually force wages in the latter down to the level of those in the former. Consequently, it is argued, high-wage countries should protect the high wage levels and standards of living of their people by the erection of protective tariff barriers. The foregoing discussion has revealed the fallaciousness of such reasoning. A country whose labor is highly effective in producing export goods can pay its labor higher wages than one whose labor is less effective and still undersell, or sell on a par with, the latter. High money wages do not necessarily cause high prices. High money wages do not penalize producers in countries where labor productivity is high. The high wages are made possible by the superior labor productivity, and are roughly proportional to that superiority. Countries of high money wages trade with those of low money wages, to their mutual advantage and without destroying the wage differentials.

**SUGGESTED READINGS**

A list of suggested readings is given at the end of Chapter VI.

## *Refinements of the Classical Theory*

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The original version of the classical theory of international trade, which has been expounded in Chapter V, has more recently been elaborated, refined, and qualified to meet the attacks of its critics and to bring it closer to reality. The latest and most complete statement of the classical theory is that of Professor Taussig, who has brought the theory to its highest state of refinement.<sup>1</sup> The present chapter is little more than a summary of the refinements of the theory worked out by Professor Taussig.

### DOMESTIC GOODS

In the preceding statement of the theory it has been assumed that all goods are traded internationally. This is obviously not true. Many goods are consumed in the same country in which they are produced and never enter international trade. Some goods are purely domestic because they must be produced close to the consumer. In this class are such perishable goods as bakery products, some fresh fruits and vegetables, custom-made goods generally, such immovable commodities as houses and other buildings, and most services, e.g., transportation, except that between nations, barbering, carpentering, plumbing, etc. The general nature of these goods precludes their entry into international commerce, except in rare instances.

Other goods are consumed close to the place of production not because they are highly perishable, or are custom-made, or are

<sup>1</sup> *International Trade*, New York, 1927. Professor Jacob Viner has recently written a valuable and scholarly work tracing the development of the theory and making a searching, and in general defensive, appraisal of it—*Studies in the Theory of International Trade*, New York, 1937.

services, but because they are so bulky relative to their value that they cannot bear the costs of transportation from one country to another. That is to say, the costs of transporting certain goods between two countries are greater than the differences in the domestic supply prices of those goods in the two countries. Transportation costs narrow the possibilities of international exchange. Many goods, which on the basis of comparative costs alone might appear proper objects of international commerce, must be relegated to the category of domestic goods when transportation costs have to be incurred. It follows from this that the supply prices of a given domestic good, which physically could be transported from one country to another, cannot differ between two national markets by more than the costs of transportation, barring tariffs or other artificial obstacles to commerce; otherwise the commodity would cease to be a domestic good and would be exported from the country having the lower costs of production to the other country. Actually, prices of identical domestic goods tend to differ between two national markets by less than the costs of transfer, while the prices of a particular international good in two national markets will tend to diverge by an amount exactly equal to the costs of transfer, plus import duties.

It must not be thought, however, that the dividing line between the international and domestic goods is hard and fast. While it may not pay to export crushed stone from the United States to England, it may be to the advantage of the United States to import crushed stone from Canada or Mexico. The difference here is, of course, the difference in transportation costs. Again, a reduction in transportation costs will make possible the international transfer of goods which under the earlier high costs of transfer would not have been profitable. When transport is by pack animal, only goods of very high value and small bulk are carried. But the mass transportation furnished by the modern railroad has so reduced the costs of transfer that such bulky articles as brick, coal, and gravel are moved in large quantities over long distances. Another factor which may change the status of goods from domestic to import or export articles is a change in the costs of producing them in one country relative to another. This, of course, will alter the comparative cost ratios between the two countries. Finally, a rise in the general price and income level of one country relative to that of another, such as

## 106 International Trade and Commercial Policy

would eventuate were gold flowing to adjust the balances of international payments, would cause one country to import goods which previously she had made for herself and the other to export some goods which she had previously produced only for her own consumption. Goods which were formerly imported might now even be exported, and those formerly exported might now be imported.

It has been shown that, where labor cost differences in different countries are absolute, the country enjoying the more favorable terms of trade will have the higher level of money wages; and that, where the cost differences are comparative, or equal, the country with the superior productive efficiency will have the higher level of money wages. Does the country with the higher level of money wages enjoy the higher standard of living? Not necessarily. So far as international goods are concerned, their prices will be the same in the two nations, barring costs of transfer, tariffs, and the like. And, because of their lower money incomes, people in the low-wage country will have to part with a larger proportion of their money incomes to purchase any given international goods than will persons in the high-wage country. But only a portion of money incomes is spent on international goods, in some countries a fairly small portion. The remaining portion of expenditures goes for domestic goods.

The prices of domestic goods may, or may not, be higher in the high-wage country than in the low-wage country. Whether they are higher or lower in the high-wage country will depend upon the relative efficiency of labor in producing domestic goods in the two countries in relation to the relative wage levels of the two countries. If labor efficiency in the domestic industries in the United States is, say, 50 per cent greater than in England, the prices of domestic goods in the two countries will be the same, provided the American wage level is exactly 50 per cent higher than the English. On the other hand, if labor efficiency in the domestic industries in the United States is only 50 per cent greater than in England, the prices of domestic goods in the United States will be higher than those in England if American wages exceed English wages by more than 50 per cent.

From this it can be seen that no general rule can be laid down relative to the standard of living of high-wage countries. As purchasers of international commodities, the inhabitants of such coun-

tries have a definite advantage from their larger money incomes because the prices of these goods are the same in the two countries, allowing for transportation costs. The prices of domestic articles may, however, be higher in high-wage countries and thus offset the advantages which citizens of such countries gain from the purchase of international goods, especially since in most countries much the larger part of money incomes is spent on domestic articles. Commodity wages may, therefore, possibly be lower in high-wage countries than in countries having lower money wages. But, to repeat, no categorical statement concerning the general level of domestic prices can be made. The prices of some domestic goods may be higher than abroad, the prices of others lower. The prices of such domestic goods as services and custom-made articles, in the production of which hand labor plays an important part, will tend to be high in a high-wage country in contradistinction to the prices of mass-production goods, in the production of which the high-wage country is more likely to possess its comparative advantage.

#### DOMESTIC WAGE DIFFERENCES

Ricardo was able to rationalize a labor theory of value by assuming that capital and different grades of labor, each with its individual wage level, were always combined in fixed proportions. It follows logically from this assumption that the costs of different goods are directly proportional to the respective quantities of labor required to produce them. This labor theory of value has been one of the weakest links in the classical theory of international trade, and critics of the classical theory have in recent years freely attacked it at this point. No searching analysis of modern productive processes is required to reveal that capital and different grades of labor are combined in widely varying proportions in the production of different goods. Moreover, different grades of labor receive differing wages. The free mobility of labor from industry to industry and from place to place within a nation, which the classical economists assumed, simply does not exist. And where labor cannot move readily from areas and occupations of low wages to better-paying fields, wages in different occupations, industries, and places will not be equalized. Instead of labor mobility, there exists labor immobility. Labor immobility gives rise to non-competing labor groups, i.e.,

## 108 International Trade and Commercial Policy

social strata of laborers from which individual workers find it so difficult to move into other strata that wage differences persist indefinitely. This means that the number of labor hours is no accurate measure of the money costs of production of different commodities. Since under competition goods tend to sell at prices close to their money costs of production, both domestically and for export, the very foundation of the theory of comparative costs is threatened. For a particular good may be cheap in a country not because labor in that country is applied with unusual effectiveness, but because the particular grade of labor employed in the production of that good is paid abnormally low wages.

To demonstrate how the existence of a lowly paid class of labor in one country may affect the flow of international trade, let us return to the case of equal differences of costs, in which it was shown that no trade was possible. The case, as it was finally worked out on page 102, showed:

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.50	\$15.00	30 cloth	\$0.50
In U.S. 10 days' labor	1.50	15.00	20 copper	0.75
In England 10 days' labor	0.75	7.50	15 cloth	0.50
In England 10 days' labor	0.75	7.50	10 copper	0.75

With equal differences in labor costs and uniform wages within each country, no trade is possible because both cloth and copper have identical supply prices in the United States and England, even though United States wages are double those of England, reflecting the superior labor effectiveness in the former country.

But now assume that in England wages are not uniform, that clothmakers receive less than workers in the copper industry, say, \$0.60 a day. Cost conditions will then change as follows:

	Wages per Day	Total Wages	Produce	Domestic Supply Prices
In U.S. 10 days' labor	\$1.50	\$15.00	30 cloth	\$0.50
In U.S. 10 days' labor	1.50	15.00	20 copper	0.75
In England 10 days' labor	0.60	6.00	15 cloth	0.40
In England 10 days' labor	0.75	7.50	10 copper	0.75

Trade is now possible because cloth is cheaper in England than in the United States, \$0.40 in the former as against \$0.50 in the latter. Since the initial trade will be in one direction only (the supply price of copper is the same in England and the United States), gold will flow from the United States to England and thus disturb price and income levels in the two countries. Wages and supply prices might finally settle down at these levels:

	Wages per Day	Total Wages	Produce	Domestic Supply Prices
In U.S. 10 days' labor	\$1.40	\$14.00	30 cloth	\$0.46 $\frac{2}{3}$
In U.S. 10 days' labor	1.40	14.00	20 copper	0.70
In England 10 days' labor	0.65	6.50	15 cloth	0.42 $\frac{2}{3}$
In England 10 days' labor	0.80	8.00	10 copper	0.80

Since cloth is cheaper in England than in the United States and copper is cheaper in the United States than in England, a permanent basis for exchange exists. The important fact to note is that here a solid foundation for trade exists, resting not upon absolute or comparative labor advantage, but upon the abnormally low wages paid one group of laborers in England. When labor advantage alone was considered, no basis for trade existed.

This illustration is obviously a simplified one. Rarely is any article the product of only one grade of labor. Most industrial processes combine many different grades of labor, some highly paid and some lowly paid. But the principle exemplified in our simple illustration—that a good may be cheap in price not because of unusual labor efficiency in this industry but merely because this industry employs labor which receives very low wages, or that a good may be high in price not because of low labor effectiveness but because the industry employs highly paid labor—requires no alteration when the actual, but more complex, conditions of industry are considered. The employment in an industry of an unusually large number of workers from a lowly paid group, or groups, may give that industry the equivalent of a comparative advantage.

Does the existence of non-competing labor groups and wide diversities of wages in any one country mean that the simple Ricardian analysis, resting on the assumptions of homogeneity in labor groups and uniformity of wages (or fixed proportions of dif-



## 110 International Trade and Commercial Policy

ferent types of labor), fails adequately to explain the actual currents of international trade? Professor Taussig, who has devoted an entire chapter of his book to non-competing labor groups, undertakes to answer the question:

The general conclusion . . . is that the existence of non-competing groups within a country affects international trade only so far as the situation thus engendered is peculiar to that country. If the groups are in the same relative positions in the exchanging countries as regards wages—if the hierarchy, so to speak, is arranged on the same plan in each—trade takes place exactly as if it were governed by the strict and simple principle of comparative costs. If the rate of wages in a given occupation is particularly low in one country, this circumstance will affect international trade exactly as would a high effectiveness of labor in that country. But if in other countries, also, the same occupation has a particularly low rate of wages, international trade will not be affected. The coefficient to be allowed for will be the same all around, and no special influence on trade between countries will be felt. Trade will develop as it would if prices within each country were governed by labor costs alone. . . .

The answer . . . depends not so much on the existence of non-competing groups in the several countries as on the similarity or dissimilarity of their make-up. Their bearing on international trade depends on whether they are of the same sort or of different sorts in the trading countries. Now, in the occidental countries—those of advanced civilization in the Western world—as a rule the stratification of industrial groups proceeds on the same lines. And it is between these countries that the principle of comparative costs is presumably of the greatest importance . . . in Western countries, to repeat, we find roughly the same social and industrial layers. The unskilled, by far the most numerous, get the lowest wages; the mechanics and well-trained stand distinctly higher; and so upward. This being the case, the differences in money costs *between* the countries are mainly determined by differences in labor costs; even tho *within* each country this factor may be profoundly modified.<sup>2</sup>

Taussig frankly grants that the course of international trade may be deflected by the existence of a lowly paid, or a highly paid, labor group from the course it would follow were labor hours alone involved, or may exist where it otherwise would not. But to produce such an effect, the lowly paid, or highly paid, labor group must be

<sup>2</sup>F. W. Taussig, *International Trade*, pp. 47-48, 56. By permission of The Macmillan Company, publishers.

unique to one country. As examples of industries which have attained export strength through the employment of unique groups of lowly paid workers, he cites the German chemical industry prior to 1914, particularly those branches based upon coal-tar products, which had at its disposal an abundant supply of highly trained chemists available at relatively low wages, and the American iron and steel industry which had at its disposal a cheap and abundant supply of unskilled laborers, the result of the unrestricted immigration into the United States in the decades immediately preceding the first World War. However, if particular groups of laborers are lowly paid, or highly paid, in all countries, the mere lowness (or highness) of wage rates affords, in itself, no country an export advantage. And because Taussig finds that the stratification of labor in the different Western countries is in general identical, he concludes that the principle that comparative advantage is based primarily upon labor costs requires no serious modification because of the existence of non-competing labor groups. The validity of this conclusion will be subjected to critical examination in the following chapter.

### CAPITAL CHARGES

In order to bring the theory of international trade closer to reality, another element of costs must be investigated—the cost of capital. The only elements of money costs considered up to this point have been labor costs. But in modern industry and agriculture, production is accomplished by labor working in collaboration with capital. And in industries utilizing such great amounts of capital as the steel, automobile, and chemical industries, to mention only a few, the proportion of total costs attributable to the use of capital may be large. What modification of the theory of comparative costs may be necessitated when account is taken of capital costs?

The use of capital gives rise to two different costs: interest charges and depreciation. Depreciation is the periodic allowance which must be made for the gradual wearing-out of capital goods, i.e., machinery, tools, plant, etc. Since such durable capital goods have a life extending over many years, it is usually found desirable to charge against costs for each accounting period a sum sufficient to amortize the value of such goods over their estimated life, rather

## 112 International Trade and Commercial Policy

than to charge the cost of replacing the capital goods to the accounting period when replacement has to be made. Depreciation charges, in turn, may be broken down into two elements: interest charges and labor costs. Machinery, plant, and other capital goods are produced by labor. So, a large proportion of their costs are merely labor costs. This labor element in the depreciation charge has already been taken into account in the theory of comparative costs. When it is stated that 10 days of labor in the United States will produce 20 units of copper, the 10 days of labor include not only the labor actually employed in mining, transporting, and smelting the ore but also the labor employed in producing all the capital goods used by these workers—tools, smelters, railroads, etc. That is, “labor hours” include all past and preparatory labor as well as current labor. Since, then, the labor cost of capital goods is included in labor hours in the theory of comparative costs, no modification of the theory is necessitated by this item.

Interest charges, however, are not so readily disposed of. Interest is the reward for waiting, and cannot be reduced to labor hours. It is a distinct and separate item of cost. Because interest charges may be a significant element of money costs in industries employing large amounts of capital goods, may not profound alterations be called for in the theory of comparative costs since this theory is premised upon the identity of money costs with labor hours?

Professor Taussig distinguishes four different sets of conditions under which capital charges may enter into the costs of production.<sup>3</sup> In the first case, interest rates in the two countries are identical, and the proportion of capital to labor is the same for all industries in both countries. Under these conditions, the only effects of interest charges upon labor costs will be a fixed percentage addition to labor costs for all commodities in both countries. Since ratios of costs will not be altered, trade will continue exactly as it would if the only costs were labor hours. In the second case, interest rates differ in the two countries, but the proportion of capital to labor is the same in all industries in both countries. Here, although the additions to labor costs due to interest charges will be higher in one country than in the other, the additions will be a fixed proportion of labor costs for all goods in any one country so that ratios of costs within a country

<sup>3</sup> *Ibid.*, Ch. VII.

will, again, not be altered. The course of trade will not be affected. In the third case, interest rates are identical in the two countries, but the proportion of capital to labor differs among industries; identical industries in the two countries, however, employ capital in the same proportions. Trade will still not be affected because, although ratios of costs will be altered, they will be altered identically in each country.

The only instance in which interest charges call for any modification of the theory of comparative costs is the fourth, in which interest rates differ in the two countries and the proportion in which capital and labor are combined differs from industry to industry. To illustrate how interest charges, under these conditions, may cause international trade to flow in channels different from those which it would follow if only labor costs had to be considered, let us return to the case of equal differences of costs, on page 102. At the labor costs there posited, no permanent trade could take place.

	Wages per Day	Total Wages	Produce	Domestic Supply Price
In U.S. 10 days' labor	\$1.50	\$15.00	30 cloth	\$0.50
In U.S. 10 days' labor	1.50	15.00	20 copper	0.75
In England 10 days' labor	0.75	7.50	15 cloth	0.50
In England 10 days' labor	0.75	7.50	10 copper	0.75

When only labor costs are included, the domestic supply prices of cloth (\$0.50) and copper (\$0.75) are identical in both England and the United States.

But suppose that the cloth industry in each country uses capital while the copper industry does not, and that the rate of interest in England is 10 per cent as opposed to 5 per cent in the United States. Suppose, too, that the American capital investment in cloth manufacture is \$200, and that during the period when \$15 is being paid for labor \$10 must be paid as interest. Let us also assume that the capital investment in cloth manufacture in England is only \$100, one-half that in the United States.<sup>4</sup> With an interest rate of 10 per

<sup>4</sup> Since the English wage rate is only one-half that of the United States, the cost of making capital goods in the former will be only one-half that of making similar goods in the latter, if English labor is as effective in making capital goods as American labor.

## 114 International Trade and Commercial Policy

	Days' Labor	Wages per Day	Total Wages	Produce	Interest Charge	Total Ex-penses	Domestic Supply Price
U.S.	10	\$1.50	\$15.00	30 cloth	5% on \$200 = \$10	\$25.00	\$0.83 $\frac{1}{3}$
U.S.	10	1.50	15.00	20 copper	nil	15.00	0.75
England	10	0.75	7.50	15 cloth	10% on \$100 = \$10	17.50	1.16 $\frac{2}{3}$
England	10	0.75	7.50	10 copper	nil	7.50	0.75

cent, the manufacture of cloth in England will then necessitate an interest payment of \$10 during the same period that labor is receiving \$7.50 in wages. Now note the effect of interest charges upon supply prices. In the United States the cost of cloth rises to \$0.83 $\frac{1}{3}$ , but in England it rises to \$1.16 $\frac{2}{3}$ . It will consequently pay England to buy her cloth from the United States. Since the cost of producing copper remains at \$0.75 in each country, however, merchandise will move in one direction only, from the United States to England. Gold will therefore flow from England to the United States in payment for the imported cloth, and will cause incomes and costs to decline in the former and to rise in the latter until equilibrium is reestablished—with England exporting copper and the United States cloth.

A situation in which trade was not possible when labor costs alone were considered, has been transformed into one in which trade is mutually profitable, merely because interest rates in the two countries differ. The basis of this trade is not comparative differences in labor costs, but *differences in interest rates*. Low interest rates tend to give a country the equivalent of a comparative advantage in goods made with much capital.

Professor Taussig maintains, however, that the modification of the theory of comparative costs necessitated by the consideration of interest charges is not quantitatively great because it applies only to a special set of circumstances. Not only must interest rates differ between countries, but the proportions of capital employed by different industries must vary as well. He points out, furthermore, that the variations in interest rates, at least between Western countries where it is most likely to enter with its special and independent effects, are not great. Whether this situation is as unimportant as Taussig holds will be examined in the following chapter.

A correction should be made for the way in which capital charges have been handled in the foregoing discussion. For simplicity of il-

illustration, it has been assumed that interest charges constitute an addition to labor costs; the inclusion of interest charges has been assumed to make costs higher than they would be if no capital were used. Obviously, this is contrary to fact. The only justification for the use of capital is that it *lowers* costs. Unless capital investment offers prospects of lower costs, it will not be made. The way in which capitalistic production lowers costs is by reducing the total labor, both past and present, involved. With the use of capital, the production of 30 cloth in the United States could be accomplished with somewhat less than 10 days' labor, say with 3 days' past labor (depreciation on capital) and 3 days' current labor. This more realistic consideration of capital in no way alters the conclusions reached in the foregoing discussion. Labor costs merely become the sum of past and current labor hours; the calculation of interest charges is in no way changed.

We may ignore for the moment the question whether interest charges call for fundamental modification of the theory of comparative costs. It should be pointed out, however, that the way in which capital is used may become an important cause of comparative advantage. A country that makes large use of plant, tools, and machinery, and makes more effective use of such capital goods than another country will have a comparative advantage in the production of commodities produced with large capital. And remember, by "more effective use of capital" is meant a smaller number of labor hours, both current and past (depreciation). England's comparative advantage in textiles, iron and steel products, and machinery during the first three-quarters of the nineteenth century was rooted in such effective use of capital. But capitalistic methods are applied with varying degrees of effectiveness in different industries and in different countries. Each country will tend to export those goods in which its use of capital is outstandingly effective. For example, England buys automobiles, typewriters, and agricultural machinery from the United States, while the latter buys textiles and some textile machinery from England; Czechoslovakia sold shoes and glass products to these two countries and bought from them textiles, automobiles, and machinery; Germany sold chemicals and tools to the very countries from which she bought machinery and textiles. The employment of capital in different countries with differing de-

## 116 International Trade and Commercial Policy

gresses of effectiveness in the various industries is one reason why the spread of industrialization to backward countries has not led to the disappearance of international trade. The best customers of some of the most highly capitalistic industries in the United States—automobile, aircraft, agricultural, industrial, and business machinery—are the industrial countries of western Europe.

### INCREASING COSTS

Hitherto, the argument has progressed upon the assumption of constant unit costs, i.e., that industries may indefinitely increase their output with an unvarying expenditure of labor per unit. While some economists believe that many industries may expand their outputs over a wide range at constant costs, it is true that many other industries can increase their outputs only at an increasing cost per unit. This is generally true of agriculture, in which a larger output necessitates cultivating poorer land or cultivating more intensively land already under cultivation. In either case, the result is that additional units of product can be forthcoming only at a greater labor cost as production enters the stage of diminishing returns.

Increasing costs are easily incorporated into the theory of comparative advantage. Where production is subject to increasing costs, trade will still be profitable, and each country will export the product of its comparative advantage. But after production has entered the stage of diminishing returns, the limits within which the barter terms of trade are set will be narrowed. Let us return to the case of comparative differences in costs (page 98) where it was assumed that

	Cloth		Copper
10 days' labor in U.S. produced	20	or	20
10 days' labor in England produced	15	or	10

It has been shown that under conditions of constant costs the United States would export copper and England would export cloth, and that the terms of trade would settle somewhere between 10 cloth for 10 copper and 15 cloth for 10 copper. Suppose, now, that the English cloth industry is operating under increasing costs so that with a small increase in production 10 days' labor would yield only

14 units of cloth, and with a still greater increase only 13 units. The exchange ratio between cloth and copper in England would then be set by *marginal* costs. With a small increase in production it would be 14 cloth for 10 copper; with a larger increase, 13 cloth for 10 copper. In the latter case, the international barter terms of trade would settle somewhere within the limits of 10:10 and 13:10 instead of the limits 10:10 and 15:10, for conditions of constant costs.

If, now, not only the English cloth industry but the American cloth industry as well operates under the law of increasing costs and the same is true of the copper industry in both countries, the limits to the barter terms of trade will be still further narrowed. For in the United States, with the expansion of copper production, the marginal costs of producing copper will rise, while, with the contraction of cloth production, the marginal costs of cloth will fall. And in England, the expansion of cloth manufacture will force marginal costs in that industry up, while the contraction of copper production will cause a reduction in marginal costs in that industry. The effects of the opening of trade upon production and costs in the two countries and upon the terms of trade may be seen by assuming that marginal costs change as follows:

	Cloth		Copper
10 days' labor in U.S. produce	22	or	18
10 days' labor in England produce	14	or	11

With these changes in the volume of production and marginal costs in the two countries, the limits of the barter terms of trade become 14:11 and  $13\frac{4}{9}$ :11.

Another result of increasing costs upon international trade is that international specialization will not go as far as under constant costs. A country may find it advantageous to import a large portion of its consumable supply of a certain commodity while at the same time it finds it profitable to produce the remaining portion of its supply at home. The industrial countries of western Europe import large quantities of cereals from southeastern Europe and North and South America, but they also raise cereals domestically, some in large quantities. The explanation of this partial specialization is the differing grades of land and the differing proportions of the factors of



## 118 International Trade and Commercial Policy

production in the various countries. While Germany may be at a disadvantage in wheat production, when compared with Argentina, so that she imports much wheat from the latter, she still has some land which is as good as, or better than, the poorest Argentine lands in cultivation. It will be worth Germany's while to grow wheat on these lands even though she continues to import much of her wheat from Argentina. The expansion of wheat culture in Argentina meets diminishing returns and forces up costs and prices. The resulting rise in the price of wheat now makes it profitable to sow to wheat some of the better German lands which at the lower previous price for wheat were more profitably devoted to some other crop. When, in the last quarter of the nineteenth century, lowered transportation costs brought into European markets from the western hemisphere a flood of cheap grain, lands devoted to wheat cultivation in England were transformed into grazing lands and truck gardens. A small quantity of wheat continued to be raised, however, on lands especially adapted to that crop.

### DECREASING COSTS

Some industries operate under decreasing costs, at least for a period of their development. By "decreasing costs" is meant a reduction in unit costs which results from an increase in the output of an industry. Decreasing costs, in the proper sense, are to be distinguished from a reduction in costs which is due to general progress in technique and organization not occasioned by the increased size of the industry. Marshall has pointed out that decreasing costs are attributable to internal and external economies. Internal economies result from an increase in the size of the plant and reflect primarily the imperfect divisibility of the factors of production. Specializing managers, special departments, and larger and more expensive mechanical units can be utilized intensively enough to warrant their adoption and to realize the reduction in costs which they make possible only by a plant which has attained a given size. The lowering of the costs of fixed and variable agents induced by the economies of larger purchases and superior financing facilities, also, will permit larger factor combinations before the point of minimum costs is attained.

External economies, on the other hand, are evoked not by an in-

crease in the size of the plant but by the expansion of the industry. They include such advantages as flow from the development of a larger and more reliable supply of skilled labor as new firms enter the industry, the improvement of means of transportation and communication, the growth of more ample banking and credit facilities, the multiplication of trade journals diffusing general knowledge of help to managers, and the reduction in the prices of machinery and parts used by the industry as these ancillary industries, in turn, are enabled to benefit from the economies of large-scale production.

Where industrial expansion does evoke external economies, continuous expansion will not persist indefinitely in reducing costs because offsetting dis-economies will eventually appear. Traffic routes will become congested, for example, and prices of raw materials and other means of production produced under conditions of increasing costs will rise. Moreover, while a small-scale industry experiencing rapid growth may realize such economies of great moment, it is more doubtful whether they will accrue to any considerable degree to a well established large-scale industry with the expansion of its output.

It seems unlikely that internal economies can function as a primary motive force for decreasing costs in an industry. For if, with a given scale of the industry, it is possible to reduce costs of production by increasing the size of the establishment, free competition will bring about that result without the stimulus of the expansion of the output of the whole industry. It will be to the interest of any producer to reduce his costs by expanding his plant in the hope of underselling his rivals. This extension in the size of the plant will cease only when either a further extension will cause costs to rise instead of to fall, because of growing technical and administrative difficulties, or free competition ceases, with the optimum size of plant so large that only one or a few firms are left. Monopoly control will result in the latter case. If a few firms remain, these firms may combine, come to a mutual understanding, or independently follow a price policy in harmony with that of their rivals.

Decreasing costs stem more directly from external economies. Before the industry is expanded, each firm will have exhausted its internal economies and attained optimum size. But where the expansion of the industry brings external economies, the plant may be

## 120 International Trade and Commercial Policy

able to expand its output beyond the previous optimum point and reach a new equilibrium with lower minimum costs.<sup>5</sup>

When and where decreasing costs do occur, the effects will be to widen the limits of the terms of trade, because, with a decline in unit costs, the country exporting the products of industries of decreasing costs will be able to offer more units of exports in exchange for her imports. Her comparative advantage in these goods is an increasing one, her labor is becoming more effective. A country with a large and rapidly growing population, a sizeable portion of whose industries are manufacturing, and/or which has extensive export markets will likely find the costs of its manufactured goods falling. Such a country will not only have a comparative advantage in manufactured goods, but will probably have a *growing* comparative advantage. It is no accident that the United States with her large internal free market and her bent for manufacturing should have gained preeminence in mass production industries as compared with small industrial nations whose development of mass production industries has been hampered by relatively small populations and obstructions to the movement of their products into export markets.

### MANY COMMODITIES

The theory up to this point has been simplified by assuming that only two goods are produced. It is now time to remove this assumption and to face the fact that every nation produces hundreds and even thousands of goods which may be exported. When many commodities are considered, the conditions of comparative costs may be illustrated by the following figures (assuming nine commodities):

Commodities	A	B	C	D	E	F	G	H	I
10 days' labor produces:									
In U.S.	30	30	30	30	30	30	30	30	30
In England	60	50	40	30	25	20	18	15	10

<sup>5</sup> Decreasing costs are ably discussed by Professor M. M. Bober, "Theoretical Aspects of the Scale of Production" in *Economics, Sociology and the Modern World, Essays in Honor of T. N. Carver*, Cambridge, 1935, pp. 73-91.

The figures in the column for each commodity, indicated by letter, represent the number of units of the commodity produced by 10 days' labor in the United States and England respectively.

The principle that a nation will export that good in the production of which it has a comparative advantage still holds. But, in which goods does each nation hold a comparative advantage? Obviously, England has such an advantage in commodity A and the United States in commodity I, and each will consequently export those respective goods. But how about the goods from B to H inclusive? When only commodities A and B are considered, the United States has a comparative advantage (or smaller disadvantage) in commodity B. But when commodities B and I are considered, England has a comparative advantage in commodity B. Will England export B, or import it? Or will B not enter into international trade? Clearly, the law of comparative costs as expounded for only two commodities affords no answer to this question.

When we consider the wage levels of the two countries, however, it can be readily ascertained which goods each country will export and which it will import. If we assume identical wages of \$3 a day in the two countries, the domestic supply prices of the nine goods in the two countries become:

Commodities		A	B	C	D	E	F	G	H	I
Wages per Day:	Domestic Supply Prices in:									
\$3.00	U.S.	\$1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
3.00	England	.50	.60	.75	1.00	1.20	1.50	1.67	2.00	3.00

Since the domestic supply prices of goods A to C, inclusive, are lower in England than in the United States, these goods will be exported by England. And since the domestic supply prices of goods E to I, inclusive, are lower in the United States, these goods will be exported by the United States. Commodity D, which has the same domestic supply price in both countries, will not enter international trade—it is a domestic good.

Consider, now, different wage levels in the two countries. Let the American wage be \$3 a day, as before, but let the English wage fall to \$2 a day. Domestic supply prices now become:

## 122 International Trade and Commercial Policy

Commodities		A	B	C	D	E	F	G	H	I
Wages per Day:	Domestic Supply Prices in:									
\$8.00	U.S.	\$1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
2.00	England	.33 $\frac{1}{3}$	.40	.50	.66 $\frac{2}{3}$	.80	1.00	1.11	1.33	2.00

With these changed wage levels, England exports as before goods A, B, and C, but in addition also goods D and E, E being previously an American export and D a domestic good. The United States now exports only G, H, and I. Good F, which was formerly an American export, is now a domestic good. The terms of trade have shifted to the advantage of the United States. Nevertheless, both countries gain from the exchange. England, which without exchange would have had to give up the equivalent of four of A for one of H, can now, for example, acquire one of H for only three of A. The gain to the United States is equally apparent. Without trade, one of A would have cost her the equivalent of one of H; but from England she can now acquire three of A for one of H. Each country will likewise gain from the purchase abroad of every commodity which it imports, although the extent of the gain will vary from commodity to commodity.

While knowledge of labor costs alone is not sufficient to indicate which goods will be exported, which will be imported, and which goods will not be traded internationally when more than two goods are involved, the disposition of all goods can be immediately determined when, in addition, the respective national wage levels are known. It will be remembered that national wage levels are, in turn, dependent upon labor productivity within each country and the play of reciprocal demand. The fall in the English price level, depicted in the second illustration, might have resulted from an increase in the British demand for American goods, or from a decline in the American demand for British goods. This would have caused an unfavorable balance of trade for England, to meet which she would have been forced to export gold. The loss of gold would have forced down English wages and supply prices and raised those in the United States (the rise in American wages is not shown, in order to simplify the illustration). Contrariwise, had the increase in demand been from the American side, American wages and supply

prices would have declined while English wages and supply prices would have risen. The number of commodities exported by the United States would have expanded, and the number exported by England would have contracted.

**SEVERAL COUNTRIES**

One additional situation remains to be examined: international trade involving more than two countries. The theory has hitherto considered only two countries. But changes in world trade currents are almost never confined to only two countries. The effects of commerce upon trade currents, terms of trade, and national income levels when a world of many countries is considered may be illustrated by including three countries. Suppose that in:

	Copper	or	Cloth
The U.S. 10 days' labor will produce	20	or	20
England 10 days' labor will produce	10	or	15
Italy 10 days' labor will produce	10	or	12

An examination of these costs reveals that labor is more effective in producing both copper and cloth in the United States than it is in the other two countries. Nevertheless, since domestic exchange ratios differ in the United States, England, and Italy, trade is possible and will be mutually advantageous where it is carried on. The United States, with her comparative advantage in copper, will export that article, while England, with her comparative advantage in cloth, will export cloth. But what of Italy? Whether Italy exports copper or cloth, or whether she even indulges in international trade at all, will be determined by the terms of trade which result from the play of reciprocal demand. If the terms settle at 10:11 which will be profitable to both England and the United States, Italy, as well as England, will export cloth to the United States and will import copper. If, however, the terms settle at 10:14, terms which still make trade advantageous to both England and the United States, Italy, like the United States, will export copper to England and import cloth from that country. Finally, if the terms settle at 10:12, there will be no possibility of international trade for Italy, although England and the United States continue to trade, because these

## 124 International Trade and Commercial Policy

terms coincide with her ratio of domestic supply prices. Which of these three courses eventuates will, to repeat, hinge upon the play of reciprocal demand.

Knowing domestic labor costs and the barter terms of trade, one may draw certain conclusions relative to national wage levels. With her superior productiveness of labor, the United States will have higher wages than either England or Italy. When the terms of trade are 10:14, so that both Italy and the United States are exporting copper, equal wages in these two countries would make the price of Italian copper double that of American copper. Because England would refuse to buy Italian copper at any price above that for American copper, barring transportation costs and assuming an identity of quality, there must be one world price for copper. If we assume that this world price for copper is \$0.50 a unit, the wages of American labor will be \$1.00 a day compared to a wage of only \$0.50 a day for Italian labor. Despite the fact that American wages are double the Italian, American copper producers can sell at the same price as Italian producers. As a matter of fact, if American wages were less than double the Italian, Americans could *undersell* Italians in the world copper market. Likewise, when the terms of trade are 10:11, so that Italy as well as England is an exporter of cloth and an importer of copper, English wages will be higher than Italian, and higher by 25 per cent, the measure of her labor superiority in producing cloth. Even with this higher wage level, English cloth manufacturers have no difficulty in meeting Italian competition in the export market for cloth. Here is revealed the basic fallacy in one of the leading arguments for a protective tariff—that a nation with a high standard of living can enjoy that high standard only behind a protective tariff wall. It has been shown that the high standard of living is purely the result of great labor effectiveness, and as such needs no tariff protection. In fact, a wage level lower than the superior effectiveness of a country's labor warrants will permit that country to undersell rival nations.

### MATERIALS, RENTS, TARIFFS

The reader may have wondered, during the preceding discussion of costs, at the omission of any reference to two items which play an important role in the expenses of most businessmen, viz., mate-

rials and rent. These may be readily disposed of. Since materials are the product of labor, and since their manufacture generally requires a certain amount of time, their costs may be reduced to labor and interest. As such, no new principles are involved.

The classical disposition of rent, too, necessitates the introduction of no new principles. Rent is regarded as a differential element, the result of diminishing returns and inequalities in the natural agents of production. The better natural agents earn something in excess of the rewards paid to the other agents of production, namely, rent. The marginal natural agents earn no such excess. Capital and labor working in collaboration with marginal natural agents produce enough to compensate themselves at the current rates, but nothing in excess of this. Costs of commodities are determined on these marginal lands,<sup>6</sup> and on these marginal lands there is no rent. Rent is not a cost of production and is consequently not an item that enters into price. It is, on the contrary, determined by price.

Import duties constitute virtual additions to the foreign supply prices of goods imported. The result of such duties is to narrow the cost ratios which set the limits to the barter terms of trade and to reduce the possible range of trade. When these duties are set high enough to wipe out the difference between domestic and foreign costs, they become protective and bring trade to an end.

#### SUMMARY

International trade will arise, if not artificially obstructed, when ratios of labor costs differ between countries. Any country will produce and export that good in which it has an absolute or comparative advantage. The barter terms of trade will lie within the limits set by comparative labor costs, and will be specifically determined by the play of reciprocal demand. Where there is an absolute advantage, respective wage levels will depend upon reciprocal demand. But where the advantage is comparative, that nation having the greater labor productivity will enjoy the higher level of wages, the degree of superiority depending upon the extent of the labor superiority and reciprocal demand. Disequilibrium in the balance of trade will be corrected by the international flow of specie and the readjustment of national incomes and prices.

<sup>6</sup>Or at the intensive margin on better lands.



## 126 International Trade and Commercial Policy

This simple statement of the theory of international trade must be modified in certain respects. The existence in a nation of a grade of labor remunerated at an unusually low rate will, where the low remuneration of that grade of labor is peculiar to that country, give that nation the equivalent of a comparative advantage in those goods in the production of which that grade of labor enters largely. Where that grade of labor is lowly paid in all countries, however, a situation which holds for most such groups in western countries, no basis for comparative advantage will exist on this account. Another factor which may give a nation the equivalent of a comparative advantage is a low interest rate, i.e., a rate low relative to that of other countries. A nation with a low interest rate will possess an advantage in the production of goods which require much capital. In industries subject to increasing costs the expansion of production, the result of the opening of trade, will narrow the limits of the terms of trade and will frequently prevent complete international specialization. When more than two goods are considered, a knowledge of respective wage levels, as well as of ratios of labor costs, is necessary in order to draw the line between export, import, and domestic goods. Reciprocal demand is a decisive factor in this establishment of national wage levels. When several countries are considered, reciprocal demand, within the limits set by comparative costs, determines where the goods are to be produced. Rent and raw materials demand no modification of the basic theory.

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## *The Mutual Interdependence Theory*

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### CRITICISM OF THE CLASSICAL THEORY

The classical theory of international trade, as presented in the two preceding chapters, has dominated economic thinking on the subject for over a century, and only in the last twenty-five years has it met serious competition. It is true that the classical theory has found less ready and universal acceptance on the continent of Europe than it has in Great Britain and the United States; this explains in part the failure of the doctrine of free trade to dominate commercial policy on the continent to the extent that it did in Great Britain during the two-thirds of a century after 1850. Although free trade has never been adopted as a policy by the United States, trade liberalism has had the practically unanimous support of American economists, and this professional championing of freedom of trade has been predicated upon the theory of comparative costs. Even the critics of the classical theory admit that, imperfect as it is, it has proved an extremely useful tool in handling many problems of international trade and finance.

The theory underwent criticism at the hands of economists both on the continent and in England even in the nineteenth century, but since the first World War this criticism has been sharpened and broadened, particularly by American and German economists. That aspect of the theory which has met perhaps the sharpest criticism has been the outmoded labor theory of value, which constitutes the foundation of the theory. Why, ask the critics, should a theory of international trade be founded upon a theory of exchange values which has been judged so unsatisfactory for general value theory that it was abandoned long ago? Today, exchange value is explained

by a demand-supply analysis in which costs are measured not in terms of labor hours but in terms of money. And labor hours cannot be a satisfactory measure of money costs because the money costs of different commodities are not proportionate to the labor hours involved in their production. The chief reasons for this failure of labor hours to reflect accurately actual money costs are non-competing labor groups and capital charges.

Professor Taussig's dismissal of non-competing groups as a factor seriously invalidating the doctrine of comparative costs has already been examined. He admits that a good *may* be low in price because its production utilizes much labor of a lowly paid category, and that consequently the mere existence of such a group of lowly paid workers *may* result in the equivalent of a comparative advantage. In other words, while "labor costs" to the business man are an important item of total costs, these business "labor costs," in turn, are a function not only of labor hours but of wage rates as well. Lower wage rates will bring just as effective a competitive advantage as a smaller number of labor hours. But unless such a lowly paid group is unique to one particular country, there is no diversion of trade from the course indicated by strict comparative labor costs. And since labor stratification in the western world is much the same in all countries, according to Taussig, the existence of non-competing groups cannot be an important cause of trade.

Now the critics point out that the exception is probably more important than the rule, for the rule assumes two conditions: first, that different types of labor are combined in the same proportions in the production of identical commodities in different countries; and second, that the proportionate wage differentials for different types of labor in the various countries are the same. That is, even though in both countries a particular type of labor is paid wages low in relation to other types, unless the degree of inferiority is the same in the two countries, that country in which the wage of that type of labor is relatively lower will have a competitive advantage which is traceable directly to labor stratification. This will also be true if one nation uses relatively more of this lowly paid labor in producing certain commodities than the other. Actually, variations in wage rates are constantly occurring, and technical changes are altering the proportions of different types of labor which are being

## 130 International Trade and Commercial Policy

used in productive processes. So, if similarity of labor stratification, in the respects defined, ever existed, it could only have been temporary.

The special set of circumstances under which Professor Taussig admits that interest charges might be an independent factor in making goods high or low in price in a particular country (and thus in making them subjects for import or for export) is that interest rates differ in different countries and that the proportions of capital to labor employed in making different goods differ. Now interest rates *do* differ and differ considerably among countries, even among the industrial countries of the western world. And it is a well-known fact that some industries use little capital per worker while others use large amounts of capital. This fact has been emphasized by Professor Ohlin, who cites the following figures of the varying amounts of capital employed per worker in a few manufacturing industries in the United States to support his point: chemicals \$10,000, iron and steel \$4,000, textiles \$1,900, tobacco \$1,700.<sup>1</sup> What is termed a "special" set of circumstances thus turns out to be a rather universal situation, in which countries with low interest rates have an advantage in the production of goods requiring much capital, and countries with high interest rates avoid the production of such goods. Since the eighteenth century, low interest rates have been a factor of no small importance in contributing to the preeminence of British manufactured goods in world export markets.

Furthermore, labor, both skilled—of all categories—and unskilled, capital, land, and enterprise are combined in widely varying proportions in the production of identical goods in different countries. Technically, several different factor combinations are possible in making most goods. What particular combination of factors will be chosen by an entrepreneur will depend upon the relative cheapness of the various factors. If land is cheap but labor dear, wheat will be raised with much land and little labor; while if the dear factor is land and the cheap factor labor, wheat-farming will become intensive. This differing cheapness of productive factors largely explains why the European peasant intensively cultivates small farms, using simple tools, while his American competitor cultivates large farms, using relatively little labor but much expensive machinery. In China laces are made by hand, but in the United States they are produced

<sup>1</sup> *Interregional and International Trade*, p. 572.

only in factories using costly machines. The reasons for this difference in the productive processes are the cheapness of labor, the scarcity of capital, and the high rates of interest in China, and the dearness of labor, the abundance of capital, and the low rates of interest in the United States. Where machinery is used, furthermore, more relatively cheap semiskilled, or even unskilled, labor can be used than where productive processes are chiefly manual. In the latter case, only the highly paid skilled craftsman is competent to produce for the market; and the high wages prevailing in countries like the United States severely handicap skilled craftsmen who attempt to compete with the craftsmen of low-wage countries.

When the variability of combinations of productive factors is weighed, it can be realized how inadequate, and even inaccurate, labor hours are as a measure of money costs. One commodity may embody 100 hours of unskilled labor. Another may have required 20 hours of unskilled and 30 of skilled labor, past and current, and the use of elaborate and expensive machinery so that a substantial interest charge was incurred. The *money* costs of the former might then be \$40—100 hours of unskilled labor at \$0.40 an hour—while those of the latter are \$80—\$8 for 20 hours of unskilled labor at \$0.40 an hour, \$60 for 30 hours of skilled labor at \$2 an hour, and an interest charge of \$12. Thus, despite a labor-hours cost of 100 for the first commodity and a labor-hours cost only half as great for the second, the second has a money-cost twice that of the first. This variability in the combinations of the productive factors may cause international trade to diverge widely from the course which ratios of mere labor hours would indicate. For not only does the variability of factor combinations cause ratios of money costs to differ from ratios of labor hours, but a given commodity may be produced in two different countries with quite different factor combinations.

Bastable has attempted to retain the real cost (the human sacrifices involved in production: irksomeness of labor, waiting, risk of enterprise) analysis and at the same time avoid the difficulties of considering only labor hours by defining a new measure of costs, a "unit of productive power," a nebulous fixed unit constructed of land, all varieties of labor, and capital. But this device fails to solve the difficulty. It has been noted that the proportions of different factors vary from industry to industry and from country to country

### 132 *International Trade and Commercial Policy*

for the same industry so that *fixed* units of productive powers simply fail to meet the realities of the situation. On the other hand, if the units are made variable, in what units are they to be measured? Hours of skilled labor, hours of unskilled labor, interest charges, acres of land, hours of management, and risk cannot be added together—they are incommensurable, unless reduced to some common denominator. The only unit in which all these costs may be expressed is money. But when money is adopted as a common denominator, real costs have been abandoned, and money costs adopted. So, the critics argue, why not start with money costs and ignore real costs completely?

Another type of attack directed against the classical theory of international trade charges the theory with being based upon a static analysis and with being quite unable to explain the dynamic world of reality. The supplies of the productive factors, it is charged, are considered by the classicists as being fixed, and while they realize that incomes may rise, or fall, they regard all incomes in a nation as rising, or falling, simultaneously, with shifts in the play of international demand. But this is contrary to fact. Changes in international demand cause certain factor prices in a country to fall at the same time that they cause others to rise. The changes in relative factor prices affect the ways in which factors are combined and the relative prices of goods, which, in turn, exert an influence upon international commodity movements. Moreover, alterations in factor prices alter the supplies of some factors but not of others. A rise in the prices of various types of skilled labor, for example, will eventually bring forth larger offerings of such labor, as more young men are attracted into these trades; while a rise in the prices of natural resources will only run up against a fixed supply of these factors. All these changes in factor prices affect commodity prices, changing the prices of different goods differently, and alter the currents of international trade. The classical theory, so the charge runs, does not take into account relative changes in factor prices, the transfer of factors, and the responses of factor supplies to factor price changes. It consequently offers an incomplete analysis of international trade movements.

Finally, the classical theory is cumbersome and unwieldy. The costs which it utilizes in its analysis are hours of labor. But businessmen do not keep their cost accounts in term of labor hours, and rarely

are such costs available. When they are, they are generally the result of special inquiry, and are obtained from money costs and production figures through statistical computation. Even then, they include only hours of *current* labor. After such labor-hours figures have been laboriously computed and compared with similar figures for the various countries, it will frequently be found that they are misleading, because wages and other cost items differ from country to country. Then "modifications" must be introduced. In addition, it has been shown that when more than two countries or more than two commodities are considered the simple doctrine of comparative costs is incapable of determining which goods will be exported. Only by falling back upon reciprocal demand can a solution to this problem be found.

To explain why a given country exports certain commodities and not others, the simple, straightforward course is, according to Professor Ohlin:

. . . to take a complete cost account in different countries for the commodity in question and to examine to what extent the cheapness of production in one country is due to low wage expenses, low interest expenses, low transportation expenses, etc. Then the next step is to go behind these cost items and examine their relation to the quantity of labor employed, the wage level, the quantity of capital employed, the interest level, etc.; in other words, the relations of the cost items to the price system in each country.<sup>2</sup>

Because the orthodox theory does not permit such a simple procedure, and because of the other criticisms of the orthodox theory, Ohlin has constructed a substitute theory based upon the mutual interdependence theory of prices. This theory starts directly with the money cost accounts, and then undertakes to explain these money costs in terms of the quantities of the factors of production used and the prices of the factors. The remainder of this chapter is devoted to a summary of Professor Ohlin's theory.

#### OHLIN'S MUTUAL INTERDEPENDENCE THEORY

Professor Ohlin regards the classical labor-hours cost approach, or any real cost approach for that matter, as at best an unwieldy and

<sup>2</sup> Bertil Ohlin, *Interregional and International Trade*, Harvard University Press, 1935, p. 582.



## 134 International Trade and Commercial Policy

cumbersome analytical tool for unraveling the problems of international trade (what goods a nation shall export and what prices goods shall command in international trade). He does not, therefore, attempt to measure real costs, but starts directly with money costs and money prices. Since the proximate reason for international trade is that commodity prices differ between nations,<sup>3</sup> it is the primary task of any theory of international trade to explain how relative prices are determined within any single nation and to demonstrate why prices of identical commodities differ among nations.<sup>4</sup>

Modern theory explains price determination by means of the demand-supply analysis. In equilibrium, under pure competition,

<sup>3</sup> The phrase "differences in commodity prices" refers necessarily to differences in *domestic supply prices*. If we disregard trade barriers and transport costs, then prices of goods traded internationally will be *identical* in price in all national markets. But this identity of prices does not put an end to trade. The inevitable result of international trade is to establish this very price identity among national markets. It is not the *selling prices* of international goods that differ in different national markets but the *costs of producing* identical goods. With identical prices for wheat, say, in two national markets, the production costs may differ so markedly between the two nations that one nation may produce much wheat while the other finds it unprofitable to produce any. When, in the foregoing discussion, it has been stated that, as a result of international gold-flows, prices in one nation rose and in another fell, what was meant was that *incomes* and *production costs* rose and fell respectively so that some goods which one of the nations formerly imported are now exported by that nation, and some formerly exported by the other are now imported, thus reestablishing equilibrium in the balance of international payments. The *selling prices* of the goods being imported and exported will remain identical in the two national markets, allowing for tariffs and transport costs.

When a nation imports a portion of her consumable supply of a given commodity, marginal costs of the domestic industry will be no higher than those of the foreign industry. But any attempt to increase domestic production will tend to raise domestic marginal costs above both foreign marginal costs and the market price.

<sup>4</sup> Ohlin's analysis is first applied to regions, which are defined as districts between which there is some kind of natural border more important than those between parts of each district. A given country may be divided into several regions. With regard to the agents of production, this means that districts have dissimilar endowments as regards industrial agents, while within each district a certain uniformity of such endowment exists. Differences of relative factor endowments which persist indicate, of course, a lack of mobility of the factors between districts. The interregional analysis is later applied virtually unchanged to international trade, since nations are merely regions distinguished from one another by such apparent features as national frontiers, tariff and trade barriers, and differences in language, monetary and legal systems, and customs.

the price of any commodity is that which equates the amount demanded and the amount supplied, and also just covers the marginal cost of production. Demand depends upon (1) the wants and desires of consumers, and (2) the money incomes of consumers. The latter, in turn, depend upon the ownership of the factors of production. The demand for any particular commodity will also be affected by the prices of all commodities, including the commodity under investigation. The supply of a particular commodity will depend upon the price of the commodity and the costs of producing it. Since demand, supply, and price are mutually interdependent, and since in equilibrium the amount demanded equals the amount supplied at a price just sufficient to cover costs of production, the costs of production must be known in order to ascertain the long-run, or equilibrium, price. The costs of producing one unit of the commodity will be determined by the quantities of the different productive factors used and the prices paid for the factors. But the quantity of each factor employed will, in turn, depend upon the physical conditions of production (the "natural and unchanging properties of the physical world which are everywhere the same") and the prices of the factors. In general, any commodity may be produced by various factor combinations. Whether to use much land and capital with little labor, or much labor with little land and capital will be determined by the prices of the respective factors. This variation in factor prices explains why agriculture is extensive in newer countries like the United States, Argentina, and Canada, where good land is abundant and cheap, and intensive in the older and more populous nations of continental Europe, where land is scarce and expensive.

The prices of the factors of production are the result of the interplay of the demands for the factors and the supplies of the factors. The demand for any factor is derived from the demands for the finished goods in the production of which this factor is used. And since units of most productive factors are employed in many different industries, the total industrial demand for a particular factor will be derived from the demands for the finished products of *all* industries employing the factor. But the demands for the finished products are themselves determined in part by the prices of the factors, because incomes are derived from ownership of the factors; and the size and distribution of incomes are vital determinants of the demand for

## 136 International Trade and Commercial Policy

goods. Finally, the quantities of the factors offered will vary with their prices; a high price will generally lead to an augmentation of the number offered, a low price to a reduction. The prices of the factors will, in turn, depend upon their scarcity. And by scarcity of the factors is meant not the smallness or largeness of their supply considered absolutely, but their shortage or abundance in relation to the demand for their use. To have any value at all, the quantity available of any factor must not exceed the quantity which could be usefully employed. Where the supply falls short of this quantity, the value placed upon any factor will be such as to restrict its use to those employments which yield it the highest returns.

The foregoing exposition gives some hint of the complexity of the pricing system. The demand for and the supply of each commodity, the demand for and supply of each productive agent, the prices of commodities, the prices of the factors of production, consumers' incomes, the quantities of the factors combined in the different productive processes—all form an intricate and mutually interdependent system. Everything depends upon everything else. No single element in this labyrinthine scheme can be regarded as a basic cause; all are determined simultaneously. Despite the complexity of the pricing problem, however, the problem is subject to mathematical solution in which all items are incorporated into equations which may then be solved simultaneously.

Our interest in the mutual interdependence theory of pricing does not lie, however, in the possibility of a mathematical solution. While the human mind can grasp the method by which the equations may be solved, the multiplicity of items which would have to be included, and the consequent multiplicity of equations, makes the actual solution unfeasible. The real value of the theory lies in its usefulness in tracing the effects upon the entire system of changes in any segment of the system. What, for example, will be the effects of shifts in demand among the various goods upon commodity prices and individual incomes? What will be the effects upon factor and commodity prices of changes in the supply of any single productive agent? How will commodity prices, incomes, and production be affected by the opening up of trade between nations? The mutual interdependence theory affords an effective means of answering these questions.

Starting with this mutual interdependence theory of pricing, Professor Ohlin has expanded and sharpened it into a keen tool for the analysis of the problems of international trade. The proximate condition of international trade is, as has previously been stated, that the costs of production of identical goods differ among nations. One other condition must hold, however, if international trade is to be lasting: the ratios of the costs of production of the various commodities must differ between countries. For if the ratios of costs between two countries are identical, all costs *may* be lower in one country than in the other, for a while. Although this will give rise to immediate trade, it will be a one-way trade, with goods being exported only from the low-cost to the high-cost country. If it is assumed, as Ohlin does, that the countries are not on the gold standard but have paper currencies not convertible into gold, importers in the high-cost country, which under these conditions will have an excess of imports over exports, will bid up the price of foreign exchange on the low-cost country. And since paper currency cannot be converted into gold at the treasury at a fixed price and gold cannot be exported to meet the deficit in the balance of payments, there will be no limit to the rise in the price of foreign exchange such as that set by the gold export point under the gold standard. Consequently, the price of foreign exchange in the high-cost country may rise considerably.

But the very rise in foreign exchange rates will act to correct the disequilibrium in the international accounts, and thus curb the rise in exchange rates, because the rise in exchange rates means that all goods in the low-cost country become more expensive in terms of the currency of the high-cost country. Note that the general level of internal prices in the low-cost country does not change. All that happens is that the currency of the low-cost country rises in price in terms of the currency of the high-cost country. Since, however, importers in the latter must pay more for foreign currency, and since the foreign currency buys only as much as formerly, the practical result is that the prices of foreign goods in terms of domestic currency have risen. The rate of exchange will be pushed up to a level at which the value of imports equals the value of exports—equilibrium will be reestablished. But where the ratios of costs in the two countries are the same, the equilibrium rate of exchange will produce an identity of the prices of all goods in the two countries.

### 138 International Trade and Commercial Policy

Therefore, no trade will be possible. Thus it is seen that the comparative cost and the mutual interdependence theories have one cardinal point in common: international trade in goods must depend upon differences in their comparative values in the countries concerned.

Since an essential condition to international trade is a dissimilarity in the cost ratios of the trading countries, a satisfactory theory of trade must expose the forces that cause relative costs of production to differ between two nations. The situation requisite to this relative variation in costs demands that the relative scarcity of the factors of production differ between the two regions. If the relative scarcity of the factors in the two regions is identical, relative factor prices will be the same and relative commodity prices also, since commodity prices reflect factor prices. Under such conditions there will be no interregional or international trade. And remember that by relative scarcity of the factors of production is meant not the absolute supply of the factors but the supply in relation to the demand. Two countries, for example, might be equipped with factors in the same relative proportions; yet if the demands for the factors in the two countries differed, the relative prices of the factors would also differ. On the other hand, two countries having dissimilar factor equipment might have identical relative factor prices if the dissimilarity in factor equipment were exactly offset by differences in demand. In a loose way, however, it is probably safe to say that absolute differences in factor equipment are responsible for differences in ratios of costs in different countries, for there seems to be no reason why differences in factor equipment should, in general, be exactly offset by differences in demand. As Ohlin puts it, "There is no reason why demand in a scantily populated region should turn especially to goods requiring much land and little labor, say wheat, and thus prevent rent from being lower, relatively to wages, than in a densely populated region, where, as people cannot after all do without, land is necessarily scarce."<sup>5</sup> But it should be remembered that, strictly speaking, the ultimate determinant of all price phenomena, and consequently international trade, is the relation between the factor supply and the demand conditions.

<sup>5</sup> Bertil Ohlin, *Interregional and International Trade*, Harvard University Press, 1935, p. 16.

Since a nation will export those goods which can be produced cheaply within her borders, i.e., cheaply as compared with other nations, and since those goods will be produced cheaply which employ large quantities of cheap factors, a nation will tend to export goods whose production involves abundant use of those production factors which are plentiful within that nation and to import goods whose production involves considerable use of those factors which are relatively scarce within that nation.

Nations like Argentina, Australia, and Canada have abundant supplies of land but relatively small supplies of capital and labor. Land is therefore cheap, but labor and capital are relatively expensive. Consequently, they export chiefly goods made by much land and relatively little capital and labor—wheat, wool, and meat—while they import largely manufactured goods utilizing much capital and labor. On the other hand, England and Belgium are richly equipped with labor and capital, but scantily supplied with land. It follows that they export highly manufactured goods, the production of which calls for much labor and capital but little land, such as textiles, hardware, glass, iron and steel products, etc., while they import raw materials and foodstuffs, whose production demands an extensive use of land. The Scandinavian countries are large exporters of wood pulp and pulpwood because they possess extensive forests of soft woods. Although many countries have land suitable for the production of raw silk, few actually produce it. Chief among the raw-silk producers are China and Japan. Raw-silk production utilizes large amounts of hand labor, and labor is so much more abundant, relative to the other factors, in China and Japan that nations where labor is scarcer find it difficult to compete with these Asiatic nations in this industry. Paradoxically, Denmark and the Netherlands, two densely populated states, have developed great herds of milch cattle and export great quantities of butter and cheese. Dairying, however, calls for much human labor and attention, and since the cattle are fed largely on imported fodders, relatively little land is needed. The huge exports of petroleum from the United States, Mexico, Venezuela, the East Indies, and Iraq are based upon the rich oil reserves of these nations. Further examples could be added almost without number.

International trade is, then, based upon differences in the relative

## 140 International Trade and Commercial Policy

abundance and relative cheapness of the various productive factors in the different countries. But the lowness of costs in world markets is a matter of *absolute* cheapness. When in Chicago skilled mechanics receive wages of \$10 a day while unskilled labor can earn only \$3.50 a day, it can be stated with assurance that unskilled labor is much less expensive in that city than skilled mechanics. The comparison is direct and significant. When steamfitters in London receive £1 a day and steamfitters in New York \$10 a day, however, who can say in which city the services of steamfitters are the cheaper? The comparison of wages in the latter case is being made in two different and superficially incommensurable units, pounds and dollars. It cannot be told from the information given which is the cheaper. But if the two currencies are bought and sold in terms of each other so that a rate of exchange of dollars for pounds prevails, a meaningful comparison becomes possible. If it is known that the rate of exchange is £1 = \$5, for example, one can say immediately that London steamfitters receive a lower money wage than New York steamfitters.

When the domestic prices of the different factors in the various countries are known and the rates of foreign exchange also, it can be determined in what country, or countries, a particular factor is cheapest and consequently what country, or countries, will export goods requiring extensive use of that factor. Consider a situation in which the prices of four different factors, A, B, C, and D, are known for two countries, and also the rate of exchange between the currencies of the two countries.

Factors	Price in United States	Price in England	Price of English Factors in Dollars at Rates of Exchange:		
			£1 = \$3	£1 = \$2	£1 = \$7
A	\$3.00	£0.3	\$0.90	\$0.60	\$ 2.10
B	3.00	0.5	1.50	1.00	3.50
C	3.00	1.0	3.00	2.00	7.00
D	3.00	2.0	6.00	4.00	14.00

If only the domestic prices of the four factors in terms of domestic currencies are known, it is not possible to state which factors are lower in price in England and which in the United States—no com-

parison is possible. Such a situation represents a state of isolation. But let trading relations be established between the two nations so that a market grows up in which their respective currencies are exchanged, and a comparison emerges. If the rate of exchange is  $\text{£}1 = \$3$ , it is clear that the prices of factors A and B are lower in England and the price of D lower in the United States, while that of C is the same in the two countries. England will export goods in the production of which factors A and B are used in large quantities; the United States will export those which use large quantities of factor D; while those goods requiring abundant use of factor C will likely be purely domestic.

A study of the table will also shed further light upon the adjustment of trade disequilibria, e.g., those arising from a shift in demand. We may start from an equilibrium foreign exchange rate of  $\text{£}1 = \$3$  and assume that the English demand for American goods increases, with no corresponding increase in the American demand for English goods. English imports will increase with no immediate increase in her exports, so that she develops a passive balance of trade, i.e., the value of her imports exceeds that of her exports. The demand in England for dollar exchange on New York will exceed the supply of dollar exchange, with the result that the price of dollars in terms of sterling will rise ( $\text{£}1$  sterling will buy fewer dollars). Suppose that the rate of dollars is bid up to  $\text{£}1 = \$2$ . The result of this rise in the sterling value of dollars is a decline in the prices of all English productive agents for Americans. Factors A and B are, of course, still cheaper in England. But factor C, formerly the same price in the two countries, now becomes cheaper in England than in the United States. Only factor D remains cheaper in the United States. Not only will Americans now buy more of those English goods into which factors A and B enter largely, but in addition they will buy goods in which large quantities of C are used, goods which were formerly made by Americans for their own use. The fall in the sterling exchange rate, and the resultant cheapening of English productive factors, will go on until Americans are induced to buy from the English goods equal in value to those imported by the English from the United States. When the value of imports equals the value of exports, the exchange rate will become stabilized—a new equilibrium will be established.



## 142 International Trade and Commercial Policy

On the other hand, if the American demand for English goods increases, with no reciprocal increase in the English demand for American goods, the adjustment will be the opposite of that just described. The American balance of trade will become passive, and the price of dollars will decline in terms of sterling. If the price of dollars drops to  $\text{£}1 = \$7$ , the corresponding American prices of British factors become those of the last column of the table. At this new exchange rate, only factor A is cheaper in England than in the United States; the three other factors are more expensive in England. The English will consequently cease to export goods requiring large amounts of factor B, as they did when the rate was  $\text{£}1 = \$3$ , and will import from the United States not only goods employing largely factor B but those employing largely factors C and D as well. As before, equilibrium and a stable rate of exchange will emerge when the value of imports equals the value of exports.

The rate of exchange is thus an important element in demarcating which of a nation's factors of production are cheap, i.e., cheaper than in foreign nations, and, in consequence, what goods that nation shall export. The rise or fall of the exchange rate will alter the absolute cheapness of some of the factors as between nations and thus expand or contract the categories of export goods and import goods, until disequilibrium in the trade balance is corrected, i.e., the value of exports equals the value of imports.<sup>6</sup>

<sup>6</sup> While under the gold standard, the adjustment of trade disequilibria is based ultimately upon changes in the flow of merchandise, just as under paper currencies with flexible exchanges, the mechanism of adjustment differs. Under the gold standard, the country having the passive trade balance will meet its adverse balance immediately by the export of gold. But the loss of gold will lead to a contraction of credit and eventually to a decline in the prices of all the factors of production, unless it is offset by appropriate central bank policies. Since the exchange rate necessarily remains virtually stable, i.e., within the gold points, the domestic fall in factor prices amounts also to a cheapening of all the factor prices of this country to foreign countries. As a result of the general decline in factor prices here, *some* of the factors which were formerly as high, or higher in price than abroad now become lower in price, and goods into the manufacture of which these now lower-priced factors enter largely will be exported. Some of these goods which are now exported may have previously been imported. So the disequilibrium, as under paper currencies, is adjusted by an increase of commodity imports and a curtailment of commodity imports.

The adjustment of the trade balance of the country having the active balance (where exports exceed imports), will take place in the same way, only in the opposite direction. Gold flows in, credit expands (unless the inflow of gold is

But the exchange rate is not an independent force; it is in no way the ultimate determiner of international prices and trade currents. The rate of exchange is rather a mere medium of adjustment, and is itself established by a more fundamental force—reciprocal demand. It is governed by the conditions of factor supply, domestic demand, and the demand of the nations for each other's products. Given these conditions, it seeks that level at which the value of imports becomes equal to the value of exports.<sup>7</sup>

### TRANSPORTATION COSTS

The consequences of transportation costs for international trade have been discussed, in part, in the statement of the classical theory. The most obvious result of introducing these costs is the reduction in the volume of goods traded internationally. To the foreign production costs of potential imported goods must be added the costs of transporting these goods to the market, so that in many instances the combined foreign production-transport costs exceed domestic costs of production, although foreign costs of production alone are below domestic costs of production. The result is that the range of international goods is narrowed and that of purely domestic goods enlarged. (Tariffs and other obstacles to trade exert the same effects.)

In addition to their effects upon the general volume of international trade, transport costs exert important influences upon the localization of industries and the composition of international trade. Since transport costs between regions vary widely, due to varying distances and/or natural difficulties of transport, the volume of trade will be large between regions easily accessible to each other when compared to that between regions separated by wide distances or connected by expensive transportation services. When two producing centers are supplying the same market, but one of

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counteracted by central bank policy), and all factor prices rise. The rise in factor prices will raise money costs of production, with eventually smaller exports and larger imports. Under the gold standard, factor prices are directly altered in the countries involved, but exchange rates remain stable within the narrow limits of the gold points; under paper, domestic factor prices remain unaltered, but the exchange rate fluctuates freely.

<sup>7</sup> When the invisible items in the balance of payments are taken into account, of course they, too, enter into the determination of the exchange rate. See Ch. IV.

## 144 International Trade and Commercial Policy

the producing centers has much heavier transport costs to this market than the other, the former will export goods whose transportation costs are low and will produce a wide diversity of domestic goods, while the latter will concentrate upon the exportation of commodities having relatively high costs of transport and will produce a range of domestic goods much smaller than the other. The variations of commodity freight rates per ton-mile, which cause commodities like wheat, petroleum, and iron ore to bear transport charges of but a small fraction of their value while others like bricks, fresh fruits, and vegetables bear charges high in comparison with their value, are due in some cases to real physical unadaptability to transportation and in others to arbitrary freight commodity classifications applied by rate-making bodies.

The existence of differential commodity freight charges governs the localization of industry in yet another way. When the materials are costly to transport, as compared with the finished goods, production will take place near the source of raw materials. On the other hand, if the raw materials are relatively cheap to transport in comparison with the finished product, production will take place close to the consuming market. Sawmills, for example, tend to locate near the consuming market when the logs can be cheaply floated down a stream conveniently connecting forests and markets; but where the markets for the lumber can be reached only by means of long and expensive overland hauls, the sawmills will be constructed close to the forests. Bread is more difficult to transport than wheat. Therefore it is manufactured near the consumer, and the chief raw material, wheat, is brought to the bakeries. But since butter is easier to transport than milk, creameries are always located in the dairy regions.

Many commodities are produced from several raw materials. In these cases, production tends to localize near the sources of the raw material most costly to transport. Where the sources of different raw materials are distant from one another and also distant from the market, the finished-goods industry will grow up where the total transportation costs are at a minimum. That portion of the American iron and steel industry which has grown up at centers along the southern shores of the Great Lakes—Gary, Cleveland, Buffalo—

uses Lake Superior iron ores and coal from the fields of Pennsylvania and Illinois, and is located in close proximity to the market. If only a portion, or none, of the weight of a material is imparted to the finished product, processing of the product will occur at the source of this material, for then the weight which is lost will not have to be transported. Fuel is the extreme type of such a material.

The location of industry and the currents of international trade are thus seen to be strongly influenced by transportation difficulties and expenses in addition to the scarcity or abundance of the factors of production. In some instances, where an industry has settled in a given locality purely as a matter of chance, the later development of a plentiful supply of skilled labor there has given that locality a lasting advantage. In other cases, climate may play an important role. A humid climate has given England a definite advantage in spinning cotton yarns over other regions which have had to rely upon artificial humidification.<sup>8</sup>

### EFFECTS OF TRADE UPON FACTOR PRICES

The immediate effect of trade between nations is the equalization of prices everywhere, allowing, of course, for transportation costs, trade obstacles, and the prices of those goods which by their very nature must be produced so close to the consumer that they do not become objects of international trade. But the equalizing effects of trade go beyond commodity prices; they also make themselves felt upon factor prices.

Consider two nations with sharply dissimilar factor equipments—England and Australia. In England, labor and capital are abundant, relative to land; in Australia, land is abundant and capital and labor relatively scarce. In a state of isolation, capital and labor are cheap and land dear in England, and land is cheap and capital and labor dear in Australia. Upon the opening of trade, England will export goods requiring extensive use of her cheap factors, i.e., manufactured goods, and Australia will export goods requiring extensive use of her cheap factor, i.e., agricultural products. When trade becomes international, however, important changes are introduced

<sup>8</sup> Problems of the localization of industry are discussed more fully by Ohlin, *op. cit.*, Chs. X–XII.

## 146 International Trade and Commercial Policy

into the pricing system. The demand for the factors is no longer merely a domestic demand; it becomes a world-wide demand. The exportation of English manufactured goods represents an increased demand for English capital and labor, a foreign demand is added to the domestic demand; and the importation of agricultural products denotes a decline in the demand for English land. The prices of English capital and labor will then rise, while the rents of English land will fall. Australian factor prices will also change. Rents will rise as exportation causes agricultural production to expand, and the prices of capital and labor will decline, because, with the importation of the cheaper English manufactures, there will be a reduced demand for these Australian factors in manufacturing. In short, international trade results in raising in all nations the prices of factors which are cheap and in lowering in all nations the prices of factors which are expensive. International differences in the relative scarcity of factors are diminished, and gaps between factor prices in different nations are narrowed.

It may be thought that the tendency of trade to reduce the relative scarcity of factors in different nations would lead to a complete international equalization of factor prices. Such a consequence is, however, hardly possible. In the first place, if such an equalization of factor prices did eventuate, the very basis of trade would disappear. And with the disappearance of trade, the forces making for such equalization would no longer be in operation, so that the old price differences would reappear. But it is highly improbable that any such equalization of factor prices ever would take place. If international trade were to bring about a complete international equality of factor prices, it could be accomplished only by concentrating the demands for each factor upon those areas where the particular factor was abundant. The demand for the productive agents, however, is always a joint demand, due to the technical requirements of production. The production of every commodity demands not merely labor, *or* land, *or* capital, but labor, *and* land, *and* capital. The opening up of an export trade for Australian agricultural products, for example, increases the demand for land, to be sure, but labor and capital are needed to work the land, so that a demand for Australian labor and capital persists despite the importation of manufactured products. In fact, so much labor and capital may be

required in agriculture that there will be no fall in their prices. They will become cheaper only relative to land.<sup>9</sup>

### THE GAIN FROM TRADE

The most important consequences of international trade are a much more efficient use of the factors of production and, as a consequence of this more efficient application of the factors, a larger output of goods than is possible in a state of isolation. And, since the amounts paid for the use of all production factors during a year are always equal to the total value of the goods produced, the increased output of goods means that the prices of the factors must rise in terms of goods—the real incomes of the factors increase. This is the chief gain from trade.

The most efficient use of all the agents of production would be realized and the highest average level of commodity incomes would be attained if the entire world were a single nation. When regions are completely isolated one from another and quite differently endowed with factor equipment, a highly inefficient employment of the factors must generally result. In a world divided up into separate regions, the most efficient utilization of the factors could be attained only if factors might be freely transferred between regions. Then it would be unnecessary, for example, to keep labor relatively unproductively at work raising wheat in regions where land was very scarce, with a consequent low marginal product of labor, because

<sup>9</sup> The higher prices for the abundant factors, which result from the opening of trade, may accentuate the inequality of factor equipment and factor prices if the higher prices for these factors cause their quantities to increase. Our knowledge of the reaction of different factors to higher rewards is limited, so that observations should be made with caution. Probably, higher wages in any *particular* trade will call forth more workers into the trade within a reasonable period. How the total labor supply will react to generally higher wages is more problematical. Higher wages for the chief breadwinner may mean that the women and children will be less apt to become members of the labor force. At a given income level, a higher interest rate is likely to call forth larger savings, but a higher interest rate may discourage investment and thus lower incomes generally. Finally, even natural resources may expand, within limits. Some lands may be readily shifted from one use to another; such shifts depend upon the prices of the respective products. High prices may also lead to increased prospecting or land reclamation, through irrigation or drainage projects. Mineral deposits that are incapable of expansion may be worked more intensively for a considerable period, and thus afford temporarily the equivalent of a larger supply.

## 148 International Trade and Commercial Policy

labor would readily be transferred to regions where land was plentiful and its marginal productivity would increase. Furthermore, regions abundantly supplied with land would not be forced to keep labor in relatively unproductive manufacturing enterprises. Identical factors would everywhere receive the same reward, and they would be assured that this reward would be set according to the highest marginal productivity, considering the given factor supply of the world and the state of productive technique. The total production of all goods taken together would be a maximum, relative to demand. But, unfortunately, the international immobility of the factors prevents this organization of factors into combinations of maximum efficiency.

Although factors cannot be moved in sufficient numbers to bring about these desirable results, and some cannot be moved at all, the mobility of goods compensates to some extent, however, for the lack of interregional mobility of the factors. Trade mitigates, in other words, the disadvantages of the unfavorable geographical distribution of the productive factors. While the abundant land of Canada cannot be transferred to the abundant labor of Belgium, the opening of trade between the two nations will, nevertheless, accomplish in part this very object. Since international trade will permit Canada to import a large portion of her manufactured goods, she can transfer labor from manufacturing to agriculture. And since Belgium can now acquire her cereals through importation, she may release labor from agriculture and transfer it to manufacturing. Thus, Canadian land uses Belgian labor, and Belgian labor uses Canadian land—at a distance. Trade helps Canada overcome her scarcity of labor, and Belgium her scarcity of land. Canadian labor enjoys a greater abundance of manufactures by producing farm products and exchanging them for manufactures than it could by producing the manufactures directly; and Belgian labor likewise enjoys a greater abundance of farm products.<sup>10</sup>

<sup>10</sup> The objection may be raised that while trade will raise the world income, a particular nation might gain nothing at all. Such, however, will not be the case. Trade will alter the relative scarcity of the factors and will cause the prices of the abundant factors in every nation to rise. Trade will also make it possible for every nation to purchase the goods now imported at a lower cost than that at which they were acquired when formerly produced at home.

But although the total value of all productive factors in terms of goods

Industries tend to become localized in the regions in which the necessary factors are least scarce. Such localization permits each region to devote its factors to their most efficient uses, to divert its resources from satisfying less important requirements (as measured by money demand) to satisfying more important requirements. International trade enables goods to be produced by combinations of factors which have the lowest scarcity value for the world as a whole. Exports and imports of goods are essentially an indirect export and import of the factors employed in making them.

### SCALE OF PRODUCTION AND THE SOCIAL CONDITIONS OF PRODUCTION

Two other forces that help shape the course of industrial localization and international trade should be mentioned. In the first place, since the factors of production are not perfectly divisible, the optimum scale of production is large in some industries. But large-scale production is feasible only when the market for the product is also large. Consequently, where the purely domestic market is too small to permit a scale of production as large as the optimum, it would be to the advantage of two countries to specialize, even though relative factor prices were identical. For the larger international market would permit production to be conducted on a scale sufficiently large to achieve the lowest unit costs.

In the second place, the "social conditions of production" vary

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will rise in all regions as a result of trade, may not the price of one factor decline relative to the others, so that that factor will be worse off than before? Not necessarily. Despite the fact that the opening of trade may reduce a particular factor's *proportionate* share in the national income, the ensuing increase in that national income may nevertheless ensure that this smaller percentage is still a greater *absolute* sum than the previous larger percentage of a smaller income. If, for example, trade reduces labor's share in the national income from 70 to 60 while rent's share rises from 10 to 20, labor will still gain if trade results in raising the national income, say, 40 per cent. Labor's income is now 84 as compared to 70, or an increase of 20 per cent, and this in spite of an increase in the share of rent from 10 to 28, or 180 per cent.

It is true that in certain instances the absolute income of a particular factor is diminished by the opening of trade. Imports of foodstuffs into Great Britain, for example, have probably lowered the rents of agricultural lands there absolutely in terms of goods as well as relatively, i.e., to the shares of the other factors. But the fact remains that despite this lowering of incomes from rents, the increases in other incomes will exceed the loss in rents—the total value of all the factors in terms of goods will rise.



## 150 International Trade and Commercial Policy

markedly from country to country. These, in turn, affect costs in identical industries differently in different countries and thus influence international trade, quite distinctly from the abundance or scarcity of the factors. One of these social conditions of production is the degree of risk involved in conducting business enterprise. In countries plagued by frequent revolutions, inefficient or fraudulent governments, or a low state of business ethics, the risks of business are much graver than in a nation with a stable government and a higher state of business morals. But these risks do not affect all industries equally. Large-scale plants, requiring a heavy capital investment, especially, find such an environment unduly hazardous, and are rarely found in countries where the risks are so burdensome. Capital will either refuse to commit itself to such nations, or will commit itself only at rates of interest prohibitively high. Agriculture is consequently better suited to such a situation.

Another "social condition" which may importantly influence the course of international trade is taxation. Taxes, as well as the prices of the factors of production, affect costs. And in so far as they weigh more heavily upon certain industries than upon others, they affect the location of industry and the flow of international commerce. A complete statement of the influence of taxation upon international trade would, however, require a thorough examination of the incidence of taxation, a subject quite outside the field of this treatise.

Trade union policy is another social element of this type. Trade unions may succeed in raising wages in certain lines well above the levels which they would have reached without union influence. The increase in wages in the favored industries will tend to depress wages in other industries, since fewer workers will be able to find employment in the unionized industries. The altered prices of labor alter costs and the course of international trade, especially if in other countries trade unionism is less successful. But higher wages need not always increase labor costs. The rise in wages may reflect an increase in productivity. If wages have previously been at starvation levels, the higher wages may so enhance labor efficiency that this will more than offset the increase in wage rates. Or the higher wages may impel business management to greater achievement and thus increase labor productivity. Professor Taussig found that the absence of an effective unionization among American steel workers

was probably a factor in the phenomenal growth of the American iron and steel industry in the decades before the first World War, a growth which placed the American industry at the fore of the world iron and steel industry, both in size and efficiency. American ironmasters did not have to face the strong opposition of their employees to technical improvements and innovations which their English competitors met from their more effectively organized employees.<sup>11</sup>

### SUMMARY

It may be helpful to recapitulate the Ohlin mutual interdependence theory. International specialization and exchange are based upon international commodity-price differences, i.e., differences in costs of production. Fundamentally, these commodity-price differences are attributable to regional differences in factor equipment. Where such differences exist, factor prices will vary from region to region, unless exactly offset by differences in demand, and it is the differences in factor prices which are directly responsible for differences in production costs. Each region (or nation) will specialize in the production of those goods which it can produce more cheaply than other regions, and the goods which it can produce cheaply are those requiring large employment of the factors which are abundant within its borders. It will import goods which it finds expensive to produce, goods requiring large use of those factors which are domestically scarce.

International exchange will tend to reduce international price differences for goods and factors. But it will never produce an identity of commodity prices, because of the costs of transfer, nor an identity of factor prices, because of the technical requirements of production. The existence of transfer costs narrows the range of goods traded, and at the same time influences industrial localization and the flow of international commerce. A more complete understanding of international trade must also take into account the economies of large-scale production and the social conditions of production.

The mutual interdependence theory of international trade is less simple and therefore more difficult to grasp than the theory of comparative costs. But it possesses the merit of being more accurate and more direct in its approach than the latter. It recognizes that goods

<sup>11</sup> *Some Aspects of the Tariff Question*, 3rd ed., 1931, pp. 135-136.

## 152 International Trade and Commercial Policy

are exported from one country to another only because the money supply prices are lower in the former than in the latter, and it seeks to explain these supply prices in terms of *all* the factors used and the prices of the factors, not in terms of the mere physical quantities of a single factor. It does not have to worry about the constancy of the proportion of labor-hours to money costs nor make modifications for divergences of the two, as does the theory of comparative costs. Its analysis is directly in terms of money costs. Defendants of the classical theory have objected to the Ohlin theory on the grounds that only an analysis in terms of real costs can be used as a basis for action when we come to decide about economic policy. This criticism has been effectively answered by Professor Ohlin: "If . . . real costs are as a rule proportional to money costs, there is every reason for building up the theory in terms of the latter, thus avoiding many difficulties, and then 'translating' the conclusions into real cost terms, when questions of economic policy are discussed. If, on the other hand, real costs are not proportional to money costs, it is difficult to believe that the former concept is a practical tool for the study of trade and price problems."<sup>12</sup>

### NOTE ON PROFESSOR HABERLER'S THEORY

The two theories of international trade expounded in this and the two preceding chapters—the doctrine of comparative costs and the mutual interdependence theory—are the two most widely accepted at the present time. A third, however, is worthy of note, although space forbids any more than brief reference to it. Professor Gottfried von Haberler has approached the problems of international trade from the viewpoint of opportunity costs. According to this approach, the price of each commodity equals the sum of its marginal money costs, marginal money costs in turn being equal to the marginal factor payments. The price of each factor equals the value of its marginal product, and all units of any factor, under competition, have the same price in all employments.

Commodity costs in any country are, then, determined by the prices of the productive agents, and it is possible to replace for two

<sup>12</sup> Bertil Ohlin, *Interregional and International Trade*, Harvard University Press, 1935, p. 590. The reader who is interested in a fuller treatment of the Ohlin theory is referred to Professor Ohlin's book, especially Chs. I–XII.

countries two series of relative labor costs by two similar series of relative prices which reflect the prices of *many* factors at the margin. By comparing these two series of price (not labor-hours) ratios, it is still possible to ascertain the possibilities of, and the potential gains from, trade by means of the principle of comparative costs, expressed in terms of relative *prices*. This explanation of international trade strongly resembles the classical version. But it takes into account *all* the productive factors instead of only *one* factor. Both versions concentrate on the establishment of two or more series of comparable exchange ratios, or relative prices.

But the opportunity cost approach, when fully stated, merges into the mutual interdependence theory. The opportunity cost theory starts with factor prices, the consequences of competitive bidding for the factors of production, and from these establishes scales of relative prices. If these scales of relative prices differ in two countries, trade is advantageous. While the mutual interdependence theory, also, is concerned with the determination of similar scales of relative prices, it starts farther back by seeking to ascertain *why* these scales should differ from country to country. It finds this explanation in the differing factor equipment of different nations. Both the opportunity cost and the mutual interdependence theories are multiple-factor theories, as distinct from the single-factor (labor) classical theory; and being multiple-factor theories, they must state relative commodity values in money terms. The opportunity cost theory, however, focuses attention directly upon the value aspect, while the mutual interdependence version is more deeply concerned with the more fundamental scarcity aspect. But as one writer has said, "when stated with full qualifications, the doctrine of opportunity cost inevitably degenerates into the conditions of general equilibrium (mutual interdependence)."<sup>13</sup>

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## ***Adjustment of Disequilibria in the Balance of International Payments: Gold Standard Conditions***

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In Chapter IV the theory of foreign exchange rates was developed. The theory there expounded is essentially a market-price theory, which describes the components of supply and demand and shows how an immediate equilibrium between these two opposing sets of forces is established. So far as this theory goes, it is satisfactory; but it falls short of being a complete theory. It fails to reveal the conditions of a durable equilibrium, or to consider how adjustment is made when international equilibrium is disturbed. While it demonstrates that fluctuations in exchange rates are, under gold standard conditions, confined to the narrow range set by the gold points, it does not reveal the basic circumstances under which gold-flows may be necessary; how great gold-flows, once initiated, must be; nor what brings them to an end. In the case of inconvertible paper currencies, where fluctuations in exchange rates are not confined within the range of the gold points, it does not disclose whether exchange rates are actually free to fluctuate without limit, or whether rate variations are subject to limits, of a sort.

This chapter and the one following are devoted to the consideration of these as yet unanswered questions. We shall consider in this chapter the nature of international equilibrium, the causes of disequilibrium, and the mechanism by which disequilibria in the balance of payments are adjusted under conditions of the gold standard. In the next chapter, we shall examine the mechanism by which

## 156 International Trade and Commercial Policy

international-payments equilibrium is reestablished when currencies are no longer tied to gold.

### THE NATURE OF INTERNATIONAL EQUILIBRIUM

The balance of payments of a nation summarizes all its economic transactions with the outside world. The credit items indicate in detail how the nation pays for its imports of merchandise and the services rendered it by foreigners; how it repays loans from foreigners; and/or how it itself extends loans to foreigners. Likewise, the debit items indicate how the rest of the world pays the nation for its merchandise exports and services rendered; repays loans; and/or extends loans to the nation. The balance of payments is in equilibrium whenever the debit and credit claims arising from the exchange of goods, services, and titles to securities, excluding short-term capital movements, cancel out. Under these conditions movements of gold or short-term capital are unnecessary to pay for unfavorable debit balances: goods, services, and loans constitute complete payment for goods, services, and loans on the opposite side of the balance sheet.<sup>1</sup>

The presence of either gold-flows or net short-term capital movements indicates that equilibrium in the balance of payments has been disturbed, i.e., that the sum of these basic credit items exceeds or falls short of the sum of the basic debit items. Net movements of short-term capital and gold-flows are essentially adjustment items.<sup>2</sup> Whenever a nation's balance of international payments is disturbed, i.e., whenever changes occur in such a way that the net balance of

<sup>1</sup> Since the net effects of excess trade balances, net flows of long-term investment capital, transfers of indemnities, and other balance-of-payments disturbances manifest themselves initially, in large part, through the movement of short-term funds, some prefer to define disequilibrium directly in terms of short-term capital movements. See James W. Angell, "Equilibrium in International Payments: The United States, 1919-1935," in *Explorations in Economics*, New York, 1936, pp. 13-14. Such a view is logical and has the merit of simplicity. Because of the importance of gold-flows in major disturbances in the balance of payments, however, it seems preferable to define disequilibrium in terms of both gold-flows and short-term capital movements.

<sup>2</sup> Short-term capital movements and gold are not always adjustment items. At times short-term capital movements are initiated independently of other items in the balance of payments. Gold frequently moves from country to country merely upon the decisions of the banking community, not because of a mal-adjusted balance of payments.

the goods, services, and long-term capital items becomes greater or less than zero and the demand far exceeds the supply of foreign exchange, or vice versa, at the existing rate of exchange, movements of short-term capital ordinarily take place which fill in the gap in the balance of payments and establish equality of the two sides of the balance sheet. If short-term capital does not move in sufficient volume to close the gap, then gold will flow to supplement the movement of short-term capital and bring the international accounts into balance.

Gold and short-term capital differ from the other items in the balance of international payments in two important respects. First, both possess a high degree of international mobility; they move with ease from one financial center to another unless their movements are subject to restrictions. Second, sizable and protracted movements of either one in one direction cannot continue indefinitely. Under gold standard conditions, and in the absence of restrictions, short-term or demand funds will flow in substantial quantities in response to slight differences in money rates, and, on occasion, as exchange rates move toward either gold point. Between the leading financial markets, differences in interest rates of as little as  $\frac{1}{2}$  of 1 per cent, or even less, have been sufficient to induce international short-term capital movements. A much greater differential is, of course, necessary to attract short-term funds to, or to expel them from, countries with poorly developed financial markets, and in countries where no financial market exists, short-term capital movements are hardly a factor in the balance of payments. There is one situation, however, in which interest-rate differentials fail to provoke short-term capital flows: when a financial crisis greatly increases the risk of devaluation or abandonment of the gold standard by a country, as by Germany and Great Britain in 1931. At such a time, any likely interest differential is apt to be insufficient to overcome the fears of loss from the anticipated currency depreciation by the country under pressure. Under the gold standard, furthermore, gold readily flows from one country to another whenever exchange rates reach the specie points, as has been explained in an earlier chapter.

A country's balance of payments may exhibit year after year, indefinitely, a credit, or debit, balance on goods, services, or long-term capital accounts, considered individually and separately, and



## 158 International Trade and Commercial Policy

still remain in equilibrium. The credit (or debit) balance in one of these categories of accounts will be offset by a debit (or credit) balance in the other two. Furthermore, a change in the size of any one of these basic items will compel offsetting changes in other items. But the mere fact that one of these items appears for a period as a net credit or debit does not exclude its remaining in that particular category for many more periods. A country's balance of payments may, for example, become adjusted to a constant rate of long-term capital inflow or outflow in the sense that the capital flow does not require any changes in prices or in the relative volumes of production of different industries nor bring itself to a halt. Any serious and protracted flows of short-term or demand balances, on the other hand, will soon exhaust themselves and give way to parallel drains of gold, for the volume of short-term funds which will readily move from nation to nation is ordinarily limited in volume. Because of the slenderness of most modern gold reserves and of the character of modern central banking practice, no country on the gold standard can tolerate a continued loss of its monetary reserves; serious deflation and even ultimate departure from the gold standard are the inevitable results. Similarly, the steady increase of gold reserves presents a difficult problem in credit control, for the continued expansion of the monetary base sets the stage for an inflationary boom. Gold and short-term capital are thus essentially adjustment items in the balance of payments: (1) they move in ready response to the appearance of disequilibria in the international payments accounts, (2) they cannot continue moving indefinitely in sizable volume in one direction,<sup>3</sup> and (3) they are important factors in the mechanism by which a durable equilibrium in the balance of payments is re-established.<sup>4</sup> This last point will be more fully developed in the final sections of the present chapter.

<sup>3</sup> One important exception to this statement is worthy of mention. A country which is an important producer of gold, like South Africa, will normally export it in substantial amounts, and its balance of payments will become adjusted to this outflow of gold. Nations which produce little or none will, on the other hand, normally acquire annually a certain proportion of the world's annual output.

<sup>4</sup> Gold-flows and movements of short-term balances may upon occasion occur merely as offsets to each other and not as a result of an actual disequilibrium in the balance of payments. This is the case when the central bank seeks to strengthen its gold reserves by drawing on its foreign balance. Such a trans-

It should be noted that balance of the international accounts, i.e., equality of credits and debits, is not the same thing as international equilibrium. The international accounts must always balance, as has been pointed out in Chapter III, for whatever a nation cannot pay it must owe for the time being, and this debt appears in the international balance sheet as an import of short-term capital. Equilibrium exists only when the net balance of credit and debit items, exclusive of net movements of short-term capital and net gold-flows,<sup>5</sup> is zero. In this case, there need be no net balance of either gold or short-term funds in the international accounts.

While the balance of payments must from the very nature of the international accounts always balance, so that there is no surplus of credits or debits to which the terms "favorable" or "unfavorable" can apply, there is one sense in which the terms are used in referring to the balance of payments, as distinct from the balance of trade. If the sum of the credit accounts for goods, services, and long-term capital exceeds the sum for the same debit accounts, the balance of payments is said to be "favorable"; if the sum of these credit accounts falls short of the sum for the same debit accounts, the balance of payments is said to be "unfavorable." Obviously, the net difference will appear as an increase, or decrease, of the nation's gold holdings and/or an increase in either foreign-owned domestic bank balances or domestically-owned foreign bank balances, and will be indicative of disequilibrium of the international accounts.

#### SOURCES OF DISTURBANCES OF EQUILIBRIUM IN THE BALANCE OF PAYMENTS

Anything which causes an alteration in the size of any item in a nation's balance of payments without providing a simultaneous offset in the form of an equal change in the same direction in some item on the opposite side of the balance sheet, or an equal change in the opposite direction in some item on the same side, disturbs the pre-existing balance of credits and debits and necessitates adjustive

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action would appear in the international accounts as an import of gold and an import of short-term capital (an invisible export). Similarly, member banks may upon occasion build up their domestic gold reserves by drawing upon their foreign balances.

<sup>5</sup> Excluding the normal gold-flows of gold-mining nations and those inspired by central banks to convert foreign balances into domestic gold reserves.

## 160 International Trade and Commercial Policy

changes to establish a new equilibrium. When a central bank draws against its foreign balance in order to build up its domestic gold reserves, no adjusting changes are necessary, for the import of short-term capital (a credit) directly and simultaneously brings an import of gold (a debit) of equal size—the balance of credits and debits is not disturbed. The same is true of a “tied” loan, where the loan contract provides that the proceeds of the loan be spent in the lending country, although banks in the borrowing country will have to permit a temporary increase in their foreign balances if the proceeds of the loan are not spent immediately. In practically all other transactions of any importance, however, a change in the size of one item in the balance of payments creates disequilibrium and forces adjustive changes.

Disturbances of international-payments equilibrium spring from basic economic, political, social, psychological, and natural changes, which may make their appearance either in the given nation or abroad. The forces which may produce international-payments disequilibrium are too numerous for full discussion here, but some of the more common may be briefly mentioned.

The sources of international disturbance may be conveniently classified into four groups, as they directly affect merchandise movements, services, capital-flows, and other items. The forces which may directly alter merchandise imports and exports are numerous. Foremost among these are changes in production costs, caused by inventions or improvements in production and business organization, changes in the relative supplies of the productive factors in different countries, discovery of new natural resources or exhaustion of old resources, and changes in domestic demand. Second, the cheapening of transport costs may bring into the orbit of international commerce goods which formerly circulated only domestically. The outward flow of agricultural products from the United States was greatly swollen in the third quarter of the last century as a result of the lowering of transport costs caused by the consolidation of local railroads into the great trunk lines and the perfection of the steamship. Third, the currents of international trade have at times been drastically altered by changes in international demands. The Crusades introduced into Europe the spices and luxury goods of the East which in the centuries that followed continued to flow west-

ward in large quantities, and the popularity of the automobile made rubber one of the largest American imports in value. Fourth, in recent decades probably no factor has been a more fertile source of fluctuations in international trade than the cyclical fluctuations of general business activity. Depression always brings a drastic shrinkage in world trade, while prosperity stimulates it. A country enjoying a boom all by itself will ordinarily experience a more rapid growth in its imports than its exports, while the opposite will be true of other countries. But production in the other countries will be activated as a result of the increased exports to the boom country. Finally, various fortuitous and miscellaneous forces may affect trade. Chief among these are crop variations, the result of weather conditions, wars, and natural disasters such as earthquakes, floods, fires, etc.

Among the service items which may display significant variations are tourist expenditures, immigrant remittances, earnings of the merchant marine, and interest and dividends. All of these are affected by fluctuations in business activity. In addition, receipts from shipping services may be greatly affected by the government's policy regarding shipping subsidies, immigrant remittances by its immigration policy. Tourist travel grows with the increase in living standards and the spread of education.

Capital-flows are one of the most serious disturbers of international equilibrium, both because of their magnitude and because of the suddenness with which they may gather momentum. Long-term capital-flows result primarily from differences in interest rates between nations. These in turn arise from the accumulation of capital in old countries, which tends to drive the interest rate down, and from the development of new investment opportunities in others, which leads to an increased demand for capital and higher interest rates. In young countries in particular, the vast opportunities for the exploitation of rich virgin resources and the widespread need for public works and new industries tend to keep interest rates high.

Under the conditions of reasonable stability of, and confidence in, the economic and political situation, short-term capital moves swiftly and smoothly to adjust disturbances in the balance of payments and restore equilibrium. If the disturbances are of brief duration, the entire adjustment may be accomplished by means of

## 162 International Trade and Commercial Policy

these short-term capital movements, and shipments of gold and more basic adjustments in price levels and incomes may be unnecessary. Where longer-run adjustments are necessary, these movements of short-term capital may prepare the way for the more basic adjustment processes. Under these conditions, the international flow of funds is confined to existing dealers' and bankers' foreign balances and a relatively small additional volume of funds which is ready to move between countries whenever moderate possibilities of gain appear. When, however, confidence in the economic and political background gives way to fears of the future, particularly fears of currency instability, the orderly movement of funds swells to a roaring torrent and threatens chaos and destruction to the entire economic structure. No longer is the motive for the international transmission of funds the prospect of a higher interest rate or a modest speculative profit. Instead, a panicky flight of funds to avoid the partial losses of currency devaluation or depreciation, the immobilization or "freezing" of foreign balances and investments, and possible total loss in case of war holds sway. The funds shifted from one center to another in quest of a secure resting place are no longer limited to the normally mobile short-term funds, but their volume is swollen by all foreign and domestic liquid assets or assets which may be quickly liquidated. Instead of operating to restore equilibrium, such short-term capital movements produce a huge gap in the balance of international credits and debits, often forcing departure from the gold standard and severe currency depreciation.

It was just such a panicky withdrawal of foreign funds from Germany during the summer of 1931, instigated by the failure of the Austrian Creditanstalt and later of the German Darmstädter und National Bank, which led first to the Hoover moratorium on reparations and war debt payments, later to the series of "standstill" agreements under which short-term creditors of Germany agreed to extend their credits for definite periods, and later to a rigorous system of exchange control and exchange-clearing agreements. A withdrawal of more than two hundred million pounds of short-term funds from England between the middle of July and September 20th of the same year brought heavy gold withdrawals from that country and eventual abandonment of the gold standard on the latter date. The imminence of a general European war after 1935

again sent a huge mass of funds seeking safety, largely to the United States. A large portion of the increase in our gold reserves, from approximately seven billion dollars at the beginning of 1934 to around twenty-two billions in 1940, represents this flight of capital.

In the fourth class of disturbing forces are war subsidies and indemnities. Where war subsidies take the form of merchandise exports or of services rendered, no problem of adjustment arises. American lend-lease advances to her allies during the late war were of this character. But where the subsidies take the form of the transmission of funds, there is an increase in the remitting country's international debits which calls for adjustive changes. England's subsidies to her Continental allies during the Napoleonic Wars were of the latter type, and led to her abandonment of the gold standard in 1797 and a depreciation of the pound sterling relative to gold and foreign currencies. The payment of a war tribute of five billion gold francs to Germany by France within the brief space of two years (1871-1873) was made possible by France's large holdings of foreign securities, whose liquidation abroad provided the means of payment. Attempts to collect reparations from Germany after the first World War met such difficulties that the Dawes Commission was appointed in 1924 to weigh Germany's ability to pay and to evolve a mechanism by which payments could be transferred to the Allied governments without jeopardy to the German economy.

The task of the remainder of the present chapter is to examine the mechanism by which international equilibrium is restored once it has been disturbed by any one or a combination of the forces described in the preceding paragraphs.

## MECHANISMS OF ADJUSTMENT OF INTERNATIONAL DISEQUILIBRIUM

### (1) THE CLASSICAL PRICE-SPECIE-FLOW MECHANISM

For a century prior to the 1920's the maintenance of equilibrium conditions between the price structures of the gold standard countries was explained by the familiar price-specie-flow mechanism, developed by Hume, Ricardo, and others. The operation of this adjustment mechanism may be best demonstrated by considering a specific case of international lending. Suppose that the United States, starting with its international payments in balance, undertakes to

## 164 International Trade and Commercial Policy

lend ten million dollars annually to Brazil and that none of the proceeds of the loan are directly spent in the United States.<sup>6</sup> The underwriters who have sold the Brazilian securities in the United States transfer the proceeds of the loans to Brazil by purchasing foreign exchange in New York for remittance to the Brazilian borrowers.<sup>7</sup> But this represents an increase in the demand for foreign exchange in New York and, in the absence of a compensating increase in the supply, forces the rate of exchange to rise, in all probability to the gold export point. An outward flow of gold from the United States toward Brazil thereupon develops. The gold surrendered by the United States must come from bank reserves, and this reduction in reserves forces a tightening of the money market and a contraction of bank credit, which, in turn, causes a drop in prices and a decline in incomes. The inflow of gold into Brazil, on the other hand, increases bank reserves, eases the money market, induces an expansion of bank credit, and ultimately causes prices and incomes to rise. In the United States, the lower costs and prices stimulate exports, and the smaller incomes discourage imports; in Brazil, the higher costs and prices cause exports to shrink, while the larger incomes bring an increase in imports. The flow of gold from the United States to Brazil will continue until United States exports have been increased and Brazilian exports reduced to the point where the United States has a merchandise export surplus of ten million dollars. At that point the flow of gold from the United States will cease, for the excess of exports will furnish a supply of foreign exchange just sufficient to balance the added demand resulting from the annual export of capital. A new equilibrium is here established with the United States having a "favorable" trade balance of ten million dollars and a debit item of equal amount on long-term capital account; Brazil will have an "unfavorable" trade balance of ten million dollars and a long-term capital credit of the

<sup>6</sup>To the extent that the proceeds of the loans are directly spent in the United States, no disturbance to the balance of payments occurs and no problem of the international transfer of purchasing power arises. In most cases of international lending, at least a portion of the loans will be spent directly in the lending country, particularly if the loans are desired for construction purposes and if the lending country is an important producer of capital goods.

<sup>7</sup>The mechanism of adjustment is not basically altered if, instead, the Brazilian borrowers draw against their balances in New York, which were established from the proceeds of the loans, dollar bills of exchange for sale in Brazil.

same amount. Since United States exports are now lower in price than formerly and Brazilian exports higher, the terms of trade have become less favorable to the former and more favorable to the latter.

*Incompleteness of the Classical Theory.* The validity of the price-specie-flow mechanism rests upon the assumption that gold movements result in prompt changes in national prices and costs so that international price equilibrium is reestablished rapidly enough to prevent any serious inroads into the gold reserves of the country whose adjustment requires the export of gold. Obviously, the failure of the adjustment forces to reestablish equilibrium, before too great a drain of gold occurs, endangers the ability of the country with the "unfavorable balance of payments" to maintain the convertibility of its currency.

There are good reasons for questioning, however, how readily prices and costs respond to the inward and outward flow of gold. Unless the banks are loaned up to the limit of their gold reserves, the loss of gold need not compel credit contraction in the lending country. Although the acquisition of new reserves may make bankers in the borrowing country more willing to lend, the actual expansion of loans and deposits may be very slow, despite low discount rates and a generous attitude of bankers, if business men see no prospects of profits and are not in a borrowing mood. Furthermore, gold flows during the past twenty-five years have more and more tended to be offset by central banking operations (rediscount-rate changes and open-market operations) in an endeavor to stabilize domestic business and insulate the domestic economy from external disturbances. Central banks have undertaken to prevent the rise in prices which an inflow is expected to generate and the fall in prices expected from an external loss of gold.

Historical studies of loan transfers covering fairly extended periods have revealed that gold movements during the periods of transfer have been surprisingly small, also that price changes have not always taken place according to the provisions of the classical analysis. Professor Taussig found that "periods of active lending have been characterized by rising prices rather than by falling prices, and that the export of goods apparently has taken place, not in connection with a cheapening of goods in the lending



## 166 International Trade and Commercial Policy

country, but in spite of the fact that the goods have seemed to be dearer at times of capital export."<sup>8</sup> He discovered furthermore that the transfer took the form of goods rather than money; that the goods seemed to move at once, almost as though there were an automatic connection between the financial operations and the movements of commodities, not with a lag as was to be expected from the very nature of the price-specie-flow mechanism.<sup>9</sup>

The apparent failure of gold-flows to produce *immediate* price changes and the large international transfers of purchasing power which have actually been consummated with negligible movements of gold, without the anticipated price changes, have raised doubts that the price-specie-flow mechanism provides a complete explanation of the processes by which equilibrium is restored in the balance of international payments. Dissatisfaction with the older theory has led to further fruitful inquiry. The refinements in the theory of international trade adjustment which have grown out of these inquiries by contemporary economists lay great stress upon movements of short-term capital and changes in incomes and demand schedules.<sup>10</sup> How these refinements have brought modern analysis into closer harmony with the facts is shown in the next section.

### (2) A MODERN THEORY OF INTERNATIONAL TRADE ADJUSTMENT

Any disturbance in international payments-equilibrium which brings about an excess of current obligations due to foreigners over current claims due from foreigners starts a movement of short-term capital into the country.<sup>11</sup> First, the rise in exchange rates which is

<sup>8</sup> From F. W. Taussig, *International Trade*, 1928, p. 239. By permission of The Macmillan Company, publishers.

<sup>9</sup> *Ibid.*, p. 260.

<sup>10</sup> Important contributions to the theory of international trade adjustment include: James W. Angell, *The Theory of International Prices*, Roland Wilson, *Capital Imports and the Terms of Trade*, Harry D. White, *The French International Accounts, 1880-1913*, Bertil Ohlin, *Interregional and International Trade*, Carl Iversen, *International Capital Movements*, Fritz Machlup, *International Trade and the National Income Multiplier*, and Charles P. Kindleberger, *International Short-Term Capital Movements*. Professor P. T. Ellsworth gives an excellent synthesis of the somewhat differing views of these writers in *International Economics*, Part I, Chs. IX and X.

<sup>11</sup> The outstanding situation in which short-term funds will *not* flow toward the country obtains when the excess of debits itself is the direct result of a flight of capital. In such a case the very source of disturbance is an *outflow* of short-term funds.

caused by the initial disturbance induces dealers to speculate on a later drop in exchange rates as these rise toward the gold export point. Dealers borrow in foreign centers by drawing bankers' long bills on these foreign centers, by discounting these bills abroad, and then by lending the proceeds in the domestic market.<sup>12</sup> Second, when dealers and bankers are carrying foreign balances in excess of normal working requirements, a rise in exchange rates may induce them to offer on the market sight bills drawn against these balances. Additional supplies of foreign exchange may in this way be forthcoming for a time without borrowing abroad. Third, the central bank may undertake to relieve pressure on the foreign exchange market by offering to sell to dealers below the gold export point some of its foreign assets. All central banks normally carry a part of their resources in the form of foreign deposits and foreign bills.

Purchases of the foreign assets of the central bank by banks and dealers will, however, reduce the legal reserves of member banks. And unless member banks had surplus reserves to start with, or unless the central bank offsets these losses in reserves by open-market purchases, the legal reserves of the banks will drop below the required minimum and will compel rediscounting or loan and deposit contraction.<sup>13</sup> Both rediscounting and credit contraction tend to generate a rise in discount rates. The rise in discount rates, in turn, constitutes a fourth factor and stimulates an inward flow of short-term capital. As soon as a sufficient interest differential relative to foreign centers appears, funds will flow in from abroad to take advantage of the higher yields now available in the domestic market. The rise in discount rates may increase the supply of foreign exchange in yet another way. Higher interest rates make it more costly to carry securities on borrowed funds and hence tend to force sales of, and to bring lower prices for, securities in the country with the deficit in its international accounts. Higher interest rates also tend to depress the prices of fixed income securities there. Included in the securities whose prices are depressed will be many which possess an international market, and the lowered prices for these in the

<sup>12</sup> Since the dealers have to pay interest on the funds borrowed abroad, they are compelled to lend at home in order to recoup this interest expense.

<sup>13</sup> It is impossible to predict what central bank policy may be in such a situation. Obviously, if it is restrictive, it will strengthen the forces working to produce higher discount rates.

## 168 International Trade and Commercial Policy

domestic market will stimulate purchases by foreign interests. This export of securities increases the supply of foreign exchange.

This inflow of short-term capital—the drawing down of foreign balances belonging to banks, dealers, and the central bank, speculative borrowing to take advantage of exchange rate fluctuations, the international transfer of funds to take advantage of interest differentials, and the international movement of securities—increases the supply of foreign exchange and fills in the initial gap in the balance of payments of the country suffering the deficit. If no additional supplies of foreign exchange were forthcoming in response to the disturbance and the rise in exchange rates, exchange rates would rise to the gold export points and gold would flow out. The elasticity in the supply of foreign exchange, however, the consequence of the high international mobility of short-term capital, brings the international accounts to an immediate equality, and at least postpones the day when it may be necessary to export gold. If the disturbance is only mild and of brief duration, such as a temporary crop failure, a sudden but short-lived increase in the demand for foreign goods, or sudden but temporary foreign remittances, the import of short-term capital may bridge over the period of disturbance without the necessity of setting in motion any longer-term adjustment processes. The gap in the balance of payments is filled by the inflow of short-term funds and, when the brief period of increased imports or remittances comes to an end, the rate of exchange will decline, and the foreign loans can be gradually liquidated.

In addition to equalizing the international debits and credits of the country faced with an adverse balance of payments, another essential function in the process of adjustment is performed by the international movement of short-term capital. It effects an international transfer of purchasing power. The very deficit in the international accounts indicates that such a net transfer of purchasing power to the citizens of the creditor nation must be made in the full amount of the current deficit. If gold should be exported to take care of the deficit, it would be apparent how purchasing power has been transferred from citizens of the deficit country to citizens of the creditor nation: the gold itself would represent a transfer of purchasing power. But an international transfer of purchasing power is no less surely effected when a movement of short-term capital takes the place of a gold-flow. Consider first what happens when the

central bank and foreign exchange dealers in the deficit country sell sight bills against their foreign balances. Importers and other remitters in the deficit country buy these foreign bills for remittance to the creditor country, while in the creditor country bank deposits are shifted from the accounts of the foreign central bank and dealers to the accounts of domestic international creditors. In the creditor country, a true international transfer of purchasing power has been consummated, from foreign banks and dealers to domestic exporters. A similar transfer of purchasing power obtains when purchasers in the creditor country buy internationally traded securities in the deficit country. The security purchasers in the creditor country may pay for their security purchases by buying from exporters in their own country bills drawn in the foreign currency against importers in the deficit country. Here, funds are turned over to exporters in the creditor country by nationals of the same country who have bought securities abroad. The recompense of the latter for the act is, of course, the receipt of the securities from the debtor country.

Finally, a transfer of purchasing power is effected when short-term loans pass from the creditor country (C) to the deficit country (D). If dealers in D draw long bills against their correspondents in C, discount these bills with banks or bill brokers in C, and sell sight bills drawn against the resulting balances to importers in D for remittance to exporters in C, a transfer of purchasing power to exporters in C takes place. This transfer of purchasing power is accomplished either by the creation of new deposits by C banks or by the shift of idle deposits from non-bank purchasers of long bills in C to C exporters. If, on the other hand, banks in C buy up the surplus of exporters' bills drawn against D importers, C banks transfer to C exporters newly created deposits. The transfer of purchasing power to creditors in C by means of short-term loans from C to D thus requires the expansion of loans and deposits by C banks, except where non-bank investors in C buy bankers' acceptances with idle funds. In order to expand their loans and deposits the banks in C must either possess excess reserves or acquire additional reserves.<sup>14</sup>

<sup>14</sup> The acquisition of additional reserves by the banks need offer no difficulty so long as the central bank is not conducting a policy of restriction. The newly acquired foreign exchange can be sold to the central bank, other assets may be rediscounted at the central bank, or gold can be imported. To the extent that gold is imported, of course, net short-term loans are reduced.

## 170 International Trade and Commercial Policy

*Long-Run Processes of Adjustment.* When the disturbance in international equilibrium is mild and of brief duration, no adjustment other than a sufficient flow of short-term capital to the deficit country may be necessary. But when the disturbance is more deeply rooted and persists over a considerable period of time, such as a prolonged stream of foreign lending, a basic and persistent increase in the demand for foreign goods, or changes in the conditions of supply resulting from changes in costs or the development of new or destruction of old resources, more fundamental adjustments are necessary. The short-term funds available for international lending are insufficient to meet a prolonged gap in the international accounts, and gold cannot flow indefinitely because the drain will endanger the government's ability to maintain the convertibility of its currency. This means that the international accounts of the deficit country can be brought into equilibrium only by an increased export of goods and services, a reduced import of goods and services, or a combination of the two. The long-run process of adjustment thus involves alterations in the flow of goods and services in contrast to the mere movement of short-term capital, which may be the only adjustment necessary when the disturbance is modest and temporary.

Although the mere movement of short-term capital is, however, insufficient in itself to reestablish a durable equilibrium in the balance of international payments when the disturbing force is deeply rooted and of long duration, it is this very flow of short-term capital which sets in motion the forces which ultimately restore equilibrium. One of the two functions of equilibrating movements of short-term capital is, as has been shown, to effect a transfer of purchasing power from the deficit country to the creditor country. This international transfer of purchasing power is the core of the mechanism by which the flow of goods and services is altered so as to bring the international accounts into equilibrium. It operates upon the international flow of goods and services in two ways: (1) by causing shifts in demand schedules, and (2) by evoking alterations in supply prices.

The processes by which the balance of trade becomes adjusted to a prolonged disturbance of equilibrium in the international accounts may best be described by an illustration. Suppose that corporations

in the United States (U.S.) borrow from lenders in England (E) over an extended period of time at the rate of one hundred million dollars a year; that the proceeds of the loans are spent entirely on construction in the United States. The immediate objective of the U.S. borrowers is to acquire one hundred million dollars of additional purchasing power. This they obtain by drawing sterling bills, with the newly issued securities attached, against lenders in E in the total sum of one hundred million dollars and by selling them to U.S. banks. The U.S. banks thereby create one hundred million dollars of new deposits, and acquire balances in E of an equal value.<sup>15</sup> New purchasing power in U.S. is created to the amount of one hundred million dollars and the incomes of the U.S. borrowers are expanded by a like amount.

The results are the same if the initiative in making the remittance is taken by the lenders in E rather than by the borrowers in U.S. The E lenders in this case buy dollar exchange from E banks. While no new bank deposits are created in U.S., there is a transfer of bank deposits in U.S. from E banks to U.S. borrowers. And this amounts to an increase in the average circular velocity of the money stock in U.S., i.e., in the number of consumer-producer-consumer cycles completed in a given period of time by the average unit of money. Deposits owned by foreign banks are usually held inactive or are loaned at short term in the capital markets. Funds lent in the money market (to finance trading in stocks and bonds or invested in treasury bills) are not ordinarily exchanged against goods and services and thus do not enter into national income. The transfer of funds in U.S. from E banks to domestic business borrowers consequently enlarges the flow of funds devoted to productive uses and increases the national income of U.S., in the same way that the enlargement of the money stock does when the remittances are made by the drawing of sterling bills by U.S. borrowers against E lenders and by the sale of these bills to domestic banks.

With their larger money incomes the U.S. borrowers will increase their purchases of a wide variety of goods. To some extent they will buy more domestic goods and services, but they will also spend some of their newly acquired purchasing power on imports and

<sup>15</sup> The movement of long-term capital from E to U.S. is hereby matched by an equal movement of short-term capital from the U.S. to E.

## 172 International Trade and Commercial Policy

goods formerly exported. To the extent that imports are increased and exports curtailed, a solution to the transfer problem is provided. The increased imports cause an increase in the demand for sterling exchange and the smaller exports effect a reduction in the supply, while the two together make it possible for the U.S. banks by selling foreign bills to importers to reduce their balances in E by the combined sum. If it is assumed that U.S. imports increase by forty million dollars and exports decline by twenty million dollars there will be a demand for the equivalent of sixty million dollars more of sterling bills, and U.S. banks will be able to dispose of sixty million of the hundred million dollars of sterling balances acquired by the purchase of sterling bills from U.S. borrowers. To this extent a permanent transfer of the loans has been accomplished, and 60 per cent of the gap in the balance of payments has been filled by an altered flow of goods. As a result of the increased imports and reduced exports, U.S. banks have been able to cut down their added foreign balances from one hundred million to forty million dollars.

The building-up of an import surplus by U.S. is, however, not arrested at this point. To the extent that the U.S. borrowers spend the proceeds of their loans on domestic goods and services, purchasing power is passed on to others in the U.S. and a secondary expansion of incomes takes place,<sup>16</sup> which may become a tertiary expansion, and so on, as each new group of income recipients in turn spends its new income. This expansion and spending of money incomes stimulates

<sup>16</sup> A secondary expansion of incomes can result from the expenditure of the proceeds of the new loans only in so far as they are not spent on goods previously exported or on new imports, or are not saved. Funds spent on goods previously exported merely supplant funds which would have been spent on these goods by foreigners. The incomes of the producers of these goods are not increased; there has merely been a switch in customers. Although the newly created deposits continue to circulate, they do not represent a net addition to the circulating medium because the export of the goods (now consumed at home) would have occasioned an equivalent increase of deposits, an increase which now does not take place from that source. Income spent on imports is transferred to foreigners, not to domestic recipients. As importers buy foreign exchange from the banks, deposits are extinguished. Finally, income which is saved rather than spent does not increase the incomes of others. Funds hoarded reduce the average circular velocity of money, and thus the effective monetary circulation.

These problems of income expansion and contraction in their relation to international trade are discussed at length by Professor Fritz Machlup in *International Trade and the National Income Multiplier*. See especially Chs. I, VIII, and IX.

general economic activity, which will in turn be supported by an expansion of bank loans and deposits.<sup>17</sup> This further expansion of U.S. incomes will lead to still greater imports and further domestic purchases of goods formerly exported. This may continue until an import surplus equal to the volume of the foreign loans has been developed, in which case the transfer problem is solved.<sup>18</sup>

Purchases of foreign services as well as foreign goods will increase, and the higher level of economic activity may cause a rise in the prices of domestic securities and thereby make the purchase of foreign securities seem attractive.<sup>19</sup> Higher stock prices may also call forth new issues for new real investment which, in turn, will encourage further consumption.<sup>20</sup>

The flow of imports and reduction of exports may be reinforced by a rise of prices in U.S. Changes in the prices of goods and the factors of production are fairly certain to occur when incomes rise. The extent and promptness of a price rise will depend upon the volume of unemployed resources and the degree of credit expansion which takes place. If there is little slack in the economic system, a fairly prompt rise in prices is to be expected. If, on the other hand, there is a considerable amount of idle resources, increased expenditures at home will bring a readier increase in output and a more tardy price rise. Even in the latter case, however, some rise in costs and prices will occur when idle, and probably less efficient, factors are put to work and plants are operated beyond their optimum capacity. Higher costs and higher domestic prices will further stimulate purchases abroad and discourage foreign purchases of home-produced goods.

It must be noted that the initial transfer of purchasing power to

<sup>17</sup> Bank credit expansion presumes, of course, the possession by the banks of unused reserves or the ability of the banks to acquire additional reserves.

<sup>18</sup> The income expansion will not continue to infinity, as might at first glance be expected. The purchase of imports and new saving cause "leakages" from the income flow which limit the total income expansion to some finite multiple of the amount of the initial spending on domestic goods and services. If the "multiplier" is 3, the total income expansion from the initial spending of \$40,000,000 on domestic goods will be \$120,000,000 ( $3 \times \$40,000,000$ ). The stimulation of additional home investment can, however, produce a still greater income expansion.

<sup>19</sup> Rising security prices and higher discount rates are, on the other hand, likely to attract an inflow of short-term capital from abroad.

<sup>20</sup> See F. Machlup, *The Stock Market, Credit, and Capital Formation*, London and New York, 1940, pp. 107 ff., 159, 316 ff.



## 174 International Trade and Commercial Policy

U.S. borrowers depends either upon the possession of U.S. balances by E banks or upon the willingness of U.S. banks to acquire foreign balances (or to import gold). If E banks do not possess U.S. balances (or balances in some third country acceptable to U.S. banks) and U.S. banks are unwilling to increase their foreign balances (or gold), foreign exchange rates will not remain stable, and no income will be created in U.S. as a result of foreign borrowing. U.S. borrowers will have to dispose of their foreign funds to those desirous of using them immediately (i.e., importers). The sale of foreign exchange will then force exchange rates down to a point low enough to induce importers to purchase all the borrowers' foreign bills in order to increase imports. Thus, an increase in imports will completely and *immediately* offset the inflow of long-term capital. No new purchasing power will come into being in U.S.<sup>21</sup>

The adjustment of the international-payments disequilibrium is not confined wholly to the transfer of purchasing power, the expansion of incomes, shifts in demand schedules, and price and cost increases in U.S. Similar developments, but in the opposite direction, take place in E. Individuals or firms in E who wish to acquire securities of U.S. borrowers buy them with E currency. The course of developments in E will thereafter depend upon the source of these funds or the alternative uses to which they would have been put. There are four possible alternative uses of these funds: (1) they may come from idle balances, (2) they may be borrowed from E banks, (3) they may represent a reduction in consumption, or (4) they may represent a reduction in domestic investment. When the lenders in E honor the sterling drafts drawn against them by borrowers in U.S., deposits in E are transferred from the lenders to U.S. banks. Now it will be remembered that foreign banks keep deposits idle, or lend them in the money market where they do not ordinarily enter into the income stream of the nation.<sup>22</sup> If, then, the funds surrendered to E banks are from idle balances or are newly borrowed deposits from E banks, no change in the effective circulation of

<sup>21</sup> See Machlup, *International Trade and the National Income Multiplier*, p. 133.

<sup>22</sup> If the E lenders transmit the loans by buying dollar drafts from E banks, instead of by honoring sterling drafts drawn against them, deposits in E are extinguished, and E banks reduce their dollar balances. The effects tend to be the same as those discussed in the body of the text.

money or the income stream in E occurs. In the former instance, idle balances of E lenders become idle balances of U.S. banks; in the latter, new deposits are created, but they immediately become immobilized. In either case, the complete burden of the adjustment is thrown upon U.S.

The results are different, however, if the purchase of U.S. securities means the sacrifice of consumption or investment in E, and it is likely that at least a portion of the funds would have been so utilized. The transfer of funds by E lenders from domestic consumption or domestic investment to U.S. banks reduces the effective monetary circulation in E and causes a net reduction in expenditures on commodities of all kinds—imports, goods formerly exported, and home-market goods. To the extent that the reduced domestic purchases of her exports is matched by an increased demand for them from U.S., there will be no reduction in the production of these goods nor in the incomes of producers of them. Part of the balances newly built up in E banks by U.S. banks will be released in payment to E exporters for the increased exports to U.S. U.S. bank balances in E will be further reduced to meet the needs of U.S. importers as the supply of E currency available in U.S. is reduced because of the decrease in E imports from U.S. To the extent, then, that the purchase of U.S. securities by E lenders is matched by a decline in imports from U.S. or in purchases of goods previously exported, no decline in domestic purchasing power in E results.

But in so far as the purchase of U.S. securities results in a decrease in purchases of E home-market goods, there is a shrinkage of purchasing power in E and a secondary decline in incomes. This decline in incomes, moderated by a reduction in saving, will continue until the total decline becomes a given multiple (determined by the multiplier) of the primary decline, the amount of the reduction in purchases of home-market goods by E foreign lenders. The further decline in E's national income will lead to still further declines in E imports and purchases of export goods. E's balance of trade will show a still greater export surplus.

This export surplus may be further widened by a fall in prices and costs in E, because the contraction of purchasing power and reduction in incomes causes unemployment. Since the export industries are sustained, at least in part, by an increase in exports, the deflation

## 176 International Trade and Commercial Policy

will be largely concentrated in industries producing for the home market. But sufficient reductions in prices of goods formerly sold only in the home market may stimulate foreign purchases of some of these goods, so that the export stream is swollen not only by larger regular exports but also by a greater diversity of exports. Furthermore, since large groups of goods are always competing with one another, which means that the mass of domestic goods and services is competing with the mass of those imported, a fall in the prices of domestic goods and services will cause the substitution of domestic for foreign goods.

The increase in purchasing power and incomes and the establishment of an import balance of trade in U.S., together with the decline in purchasing power and incomes and the development of an export balance of trade in E, provide the means for a smooth and efficient transfer of the loans from E to U.S., not only in the current year, but in future years. E's excess of foreign exchange from her export surplus furnishes a supply of foreign exchange available to E lenders for remittance to U.S., while, from the U.S. point of view, the foreign exchange made available by E lenders provides the means of paying for her import surplus.

It may help in comprehending the adjustment process to present in the following summary table the changes which lead to an ~~E~~ export surplus in the lending country and an ~~U~~ import surplus in the borrowing country.<sup>23</sup> The last item in the table calls for brief comment.

U.S. (Borrowing Country)	E (Lending Country)
Increase in purchasing power; primary expansion in incomes	Decrease in purchasing power; primary decline in incomes
Increase in home investment and consumption	Decrease in home investment and consumption
Secondary expansion in incomes	Secondary decline in incomes
Increases in prices of commodities and factors	Fall in prices of commodities and factors
Increase in imports; decline in exports	Decrease in imports; increase in exports
Import balance of trade	Export balance of trade
Net import of capital	Net export of capital

<sup>23</sup> Adapted from Machlup, *International Trade and the National Income Multiplier*, p. 142.

Although the entire machinery of adjustment is set in motion by an inflow of long-term capital into U.S., initially the inflow of long-term capital is offset by an outflow, in equal volume, of short-term capital, i.e., by the decline of the balances of E banks in U.S. or by an increase of the foreign assets of U.S. banks. No *net* flow of capital yet takes place. It is only as U.S. develops an import surplus (E develops an export surplus) and U.S. banks are enabled to reduce their foreign balances, or E banks are enabled to increase their U.S. balances, that a *net* movement of capital is effected.

The adjustment to a new situation of international lending may involve changes in the industrial structures of the nations concerned. In the borrowing country, the increased demand for home-market goods will produce larger profits, lead to higher rewards for the factors of production, and result in an expansion of output of these industries, while the decrease in the foreign demand for export goods will lead to lower profits or even losses, unemployment and lower rewards for labor and the other production factors, and the eventual elimination of firms. In the lending country, the export industries will be stimulated while the home-market industries are depressed, and there will be a tendency to shift factors from the latter to the former, as rewards in the one fall and in the other, rise.<sup>24</sup>

This theory of trade adjustment retains the essence of the classical view: viz., that international-payments disequilibria tend to be self-correcting through basic changes in credit and incomes which in turn alter the balance of trade. It differs from the classical explanation chiefly in that the adjustment is not dependent upon an initial flow of gold, and also in that changes in prices and costs may not be necessary, although they may and usually will take place. It is broadly applicable to any situation in which a sufficient degree of foreign exchange stability is maintained to permit short-term credit transactions.<sup>25</sup>

<sup>24</sup> The effect on the export industries in the borrowing country might be merely to check an expansion that otherwise would have occurred, rather than to cause an actual contraction. If industry in the lending country is expanding, the effect of the loan might be to slow up the expansion of home-market industries rather than to cause them to contract.

<sup>25</sup> Obviously, if for any reason short-term credit transactions are not possible, the only way in which the initial transfer of purchasing power can be made is by the shipment of gold.

## 178 International Trade and Commercial Policy

The present theory seems to be in closer agreement with the facts than the classical theory. Under gold standard conditions, international gold-flows are the product either of pressure on the foreign exchange markets when short-term capital is not free to move in sufficient quantities, or of the desire to hold gold itself. Gold may be demanded to enlarge banking and monetary reserves, for industrial uses, or for hoarding. The experiences of Canada during the fourteen years of international borrowing (1900–1914) seem to support the present theory. As the loans from abroad were made available to the Canadian borrowers, Canadian deposits increased, incomes expanded, domestic costs and prices rose, and the nation developed an import surplus—all without an inflow of gold. Gradually, as they found their demand liabilities outstripping a safe ratio to their gold reserves, the Canadian banks, which during the period of international borrowing had been building up their short-term balances in London and New York, would draw against their New York balances in order to import gold and strengthen their reserve positions.<sup>26</sup> Gold flowed into Canada, in other words, only as it was deemed necessary to augment banking reserves; the *initial* transfer of purchasing power, which made possible the international lending operation, was effected by the flexible credit policy of the Canadian banks and by their willingness to acquire foreign balances.

The ease with which large unilateral payments, such as loans or indemnities, may be transferred between nations depends upon flexible banking policies, the existence of a body of short-term capital ever ready to jump national boundaries in response to prospects of higher earnings, and/or the possession of gold reserves available for export. The breakdown of German reparations payments after 1928 illustrates the difficulty of effecting large international payments where these conditions are absent. Between 1924 and 1928 Germany was able to transfer large sums to the Allied nations on reparations account because the processes of transfer were smoothed by the flow of loans to Germany. After 1928, however, when the flow of loans toward Germany practically ceased, the lack of German foreign balances, inadequate gold reserves, and the unwillingness of foreign

<sup>26</sup> Jacob Viner, *Canada's Balance of International Indebtedness, 1900–1913*, Cambridge, 1924.

banks to increase their balances in Germany, effectively checked further attempts to transfer reparations payments.

The transfer of a loan from one country to another may not involve a contraction of credit and incomes in the lending country, but may accompany an actual expansion of incomes there. This will be the case where the foreign securities are purchased with idle funds or with the proceeds of new bank loans. Although the purchase of foreign securities causes the transfer of domestic deposits to foreign banks, there is no reduction in the effective monetary circulation nor in incomes in the lending country because the funds transferred to foreign account were either formerly idle or are newly created deposits. Nevertheless, there is an expansion in both the effective monetary circulation and incomes in the borrowing country, as previously described, and the resulting increase in exports from the lending country will cause an increase in the circulation of money and in incomes in the latter country.<sup>27</sup> Thus foreign investment may foster a domestic boom and cause domestic incomes to increase in the same way that domestic investment would, although in lesser degree. This explains how it is possible for periods of active lending to be characterized by rising rather than falling prices and for the export of goods from the lending country to increase in spite of the fact that the goods have seemed dearer at times of great capital export, phenomena which puzzled Professor Taussig.<sup>28</sup> Prices and incomes will probably rise even faster in the borrowing country. The stimulating effects of foreign lending to the economy of the lending country will be even more pronounced where the capital-goods producing industries are highly developed in the lending country but virtually non-existent in the borrowing country. This was the case with the major part of British foreign investments during the nineteenth century.

Historically, foreign borrowing and the increased import of goods have both frequently sprung from a single underlying set of causes. The construction of railroads and public utilities, the erection of

<sup>27</sup> The increase in exports to the borrowing country will cause banks of that country to release deposits in the lending country to exporters there. These funds thus pass from inactive to active accounts.

<sup>28</sup> *Op. cit.*, p. 239.

## 180 International Trade and Commercial Policy

industrial plants, and the development of mines and other natural resources in relatively undeveloped countries possessing no capital markets and little manufacturing industry require not only the capital goods which construction demands but the means of paying for the goods as well. The domestic economy can furnish neither. If construction is to take place, both the goods and the wherewithal to pay for them must be furnished by foreigners. In that case there is no problem of transfer; the capital import is necessitated by the increased demands for imports of commodities. Construction, foreign borrowing, and increased importation are all parts of one organic whole.

*Disequilibrium Arising from Domestic Boom.* A purely domestic boom accompanied by credit expansion, increased production, rising prices, and higher incomes tends to increase imports and reduce exports, and thus to create a deficit in the balance of payments. Restoration of equilibrium may be achieved by one or both of two routes. Booms are characterized by rising interest rates, resulting from the pressure of credit expansion upon bank reserves, and advancing security prices, reflecting improved business earnings. Higher interest rates and rising security prices both tend to attract foreign capital, both long-term and short-term, quite possibly in quantities sufficient to restore equilibrium in the international accounts. The inflow of capital may even be so great as to turn the international deficit into a surplus and lead to an inflow of gold.

Adjustment will also be promoted through the channels of trade. The larger purchases of foreign products lead to a transfer of purchasing power to foreign countries and higher incomes abroad. Higher foreign incomes result in greater purchases by foreigners, both of their own domestic products and of imported products. Greater imports into foreign countries will stimulate exports from the country in which the boom originated, and help offset the latter's increased imports. This offsetting trade movement will be strengthened if the increase in foreign incomes encourages trade expansion abroad, as is highly probable. The tendency for an expansion in business activity in one country to spread to other countries by stimulating export industries abroad is an important element in promoting a restoration of international equilibrium originally disturbed by the boom itself.

*Disturbances Arising from Changes in International Demand.* International equilibrium is at times disturbed by an increase in the demand of one country for the products of another country, or countries. Where such a change in demand is not merely temporary, fundamental changes in the various economies are called for.

Assume a sharp and lasting increase in the United States demand for Brazilian coffee. Increased American purchases of foreign exchange (which may be met by a reduction in foreign balances or by increased foreign borrowing by American banks) will cause credit contraction and lower incomes in the United States, which in turn will lead to smaller imports of goods other than coffee. In Brazil, coffee exporters will realize higher incomes as deposits are shifted to them from United States banks, and the incomes of other Brazilians will expand as coffee exporters spend their larger incomes. Imports into Brazil, including those from the United States, will rise. The flow of goods from the United States may be further enlarged by a fall in prices and costs there as credit contracts and incomes fall. The drop in American imports (other than coffee) and the rise in exports will continue until the trade balance is adjusted to the greater coffee purchases.

In the United States there will be a reallocation of the productive factors—from those domestic industries which have experienced a decrease in demand to the export industries. In Brazil, factors will be shifted to some extent from some domestic industries (those which have experienced little increase in the demand for their products) and other export industries into the more profitable coffee production. Prices and incomes in the United States will be lower, those in Brazil higher.

*Gold as an Equilibrating Factor.* In describing these various adjustment processes little mention has been made of gold movements. As long as short-term capital moves in volume sufficient to bring about the transfers of purchasing power necessary to set in operation the adjustment forces described above, gold will flow only as it is needed to fortify gold reserves. If, however, short-term capital fails to move in sufficient quantities, gold must move. Gold smooths the transfer operations in two ways. It represents a transfer of purchasing power in itself, and through its effect upon bank reserves it influences interest rates, credit expansion and contraction, prices



## 182 International Trade and Commercial Policy

and costs, and even the level of business activity. In general, gold movements tend to operate in the restoration of equilibrium in the same manner as short-term capital movements: either an outflow of gold or an inflow of short-term capital causes a contraction in the domestic circulation of money, whereas an inflow of gold or an outflow of short-term capital causes an expansion of the monetary circulation.<sup>29</sup>

*Ease of Adjustment Affected by Types of Commodities Involved in Foreign Trade.* The rapidity and ease with which a country's balance of payments may be restored to equilibrium depend to a great extent upon the type of goods which make up its exports and imports. A country which normally imports high-priced consumption goods and durable goods will find it relatively simple, when faced with an adverse balance of payments, to postpone its purchases of durable goods and possibly to switch from purchases of high-priced goods to cheaper ones. A country which imports chiefly foodstuffs and raw materials, on the other hand, will find it difficult to reduce its imports and bring its international payments into equilibrium.

<sup>29</sup> In certain respects the effects produced by gold-flows differ from those produced by short-term capital movements. If the banks in a country which loses gold are "loaned up," the loss of gold originates not only a primary decline in purchasing power but a secondary decline as well, since the loss in reserves compels the banks to contract credit in order to avoid reserve deficiencies. An inflow of short-term capital, on the other hand, immobilizes deposits (and reduces purchasing power) only to the extent of the capital inflow. Furthermore, even if the banking system is not "loaned up," a loss of gold will probably curtail purchasing power more effectively than an inflow of short-term capital. The future ability of the banks to expand their credit will be more rigorously restricted by an outflow of gold because reserves are thereby reduced, whereas an inflow of short-term funds in equal amount merely immobilizes deposits without reducing reserves. Also, the actual reduction in effective purchasing power may be less than 100 per cent of the capital inflow if some of the balances of foreign banks are loaned in the money markets and eventually find their way into commercial and industrial channels. Finally, the shipment of gold constitutes ultimate payment, whereas the inflow of short-term capital merely postpones payment. Meeting a deficit in the international accounts by an inflow of short-term capital may prove embarrassing at some future date if foreign owners of balances suddenly demand payment. By maintaining discount rates sufficiently high to produce a continuous inflow of short-term funds between 1925 and 1931 England managed to prevent a loss of gold in the face of a persistent deficit in her international accounts, but sudden demands for the payment of accounts due foreigners caused in the latter year a severe banking crisis and forced abandonment of the gold standard.

The ease with which a country brings its balance of payments into equilibrium will also be affected by the elasticity of foreign demand for its products. Where the elasticity of foreign demand is less than unity the restoration of equilibrium will be difficult, for the total value of its exports will fall rather than rise in consequence of reductions in the prices of its products. The probability that this elasticity will be less than unity is, however, not great, except in the case of countries producing a limited variety of agricultural goods. Even if the world demand for certain goods is inelastic, the demand for the particular product of one country in competition with similar products of all other countries is likely to be elastic, since the exports of the commodity by any one country are unlikely to be more than a small fraction of the world supply. Moreover, not only must actual exports be considered but potential exports as well; a small price reduction may bring into the export category goods formerly consumed only at home. From this it follows that, other things being equal, the more diversified a nation's output, the more elastic will be the foreign demand for its exports.<sup>80</sup>

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## ***International-Payments Equilibrium Under Inconvertible Paper Currencies***

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We have analyzed in Chapters IV and VIII the forces which affect foreign exchange rates and the mechanism by which disequilibria in the balance of international payments become adjusted under gold standard conditions. It has been shown that every foreign exchange rate is merely a price, and, like every price in a free market, is established by the forces of supply and demand. The distinctive feature of foreign exchange rates when each currency is freely convertible into a fixed quantity of gold is the rigid confinement of rate fluctuations within the range set by the limits of the gold points. Assured of nothing more than slight variations in exchange rates, bankers are quite willing, under gold standard conditions, to borrow or lend abroad and to build up or reduce their foreign balances whenever the appearance of money-rate differentials or fluctuations in foreign exchange rates makes such action profitable. These short-term capital movements provide the means by which international transfers of purchasing power are effected,<sup>1</sup> and it is the transfers of purchasing power which alter the currents of international trade in such a fashion as to restore international equilibrium, once it has been disturbed.

When currencies are no longer convertible into gold, fluctuations in exchange rates are not confined to the range defined by the gold points. Rather, rates are free to vary widely—theoretically, it might appear, without limit. Foreign exchange-rate fluctuations produce

<sup>1</sup> Gold provides another.

## 186 International Trade and Commercial Policy

important effects upon trade currents, however, and these, in turn, react upon exchange rates. With foreign exchange rates subject to wide and unpredictable variations, furthermore, international short-term capital movements encounter serious hazards, and equilibrating movements of capital no longer take place.<sup>2</sup> Transfers of purchasing power by means of gold shipments cannot be made because gold is not used as a monetary base.<sup>3</sup> Since international transfers of purchasing power cannot be made, the mechanism by which international-payments disequilibria are adjusted under gold standard conditions cannot function where currencies are not convertible into gold. Under independent paper currencies, therefore, there must be a different mechanism of adjustment.

One of the main tasks of this chapter will be to analyze how equilibrium is restored in the balance of international payments under independent paper currencies; another, to determine whether there is any norm, similar to mint parity, about which exchange rates tend to fluctuate when currencies are not convertible into gold.

### THE PURCHASING-POWER PARITY THEORY

During the first World War and the years immediately following, when foreign exchange markets were disorganized and exchange rates deviated widely from prewar mint parities, a theory emerged which held that even under a regime of inconvertible paper currencies there exists a normal rate of exchange, similar to mint parity, about which the actual rate fluctuates from day to day and from which it cannot stray far. This norm is called the purchasing-power parity.<sup>4</sup> Unlike mint parity, purchasing-power parity is not depend-

<sup>2</sup> This conclusion is subject to qualification. Sometimes governments are able to maintain relatively stable exchange rates over considerable periods of time, so that short-term capital movements do take place, even though currencies are not convertible into gold. This possibility is treated at greater length later in this chapter.

<sup>3</sup> Sometimes, where currencies are divorced from gold, the monetary authorities continue to use the metal as a means of settling international balances, although the price of gold is, under such circumstances, variable.

<sup>4</sup> The modern version of the theory is associated with the name of Professor Gustav Cassel, whose first English version appeared in the *Economic Journal* in 1916. He later expanded his views in *Money and Foreign Exchange after 1914*, New York, 1922. Professor Cassel did not, however, invent the theory.

ent upon the gold content of the respective currencies, but is based instead upon the internal purchasing power of the currencies in their respective countries. And unlike mint parity, purchasing-power parity is not a fixed rate but varies as the ratio of these internal purchasing powers varies. Any variation of actual exchange rates from purchasing-power parities sets in operation forces which tend to drive them back to purchasing-power parities. The purchasing-power parity theory is thus an attempt specifically to relate rates of exchange to price levels.

The doctrine of purchasing-power parity rests upon the proposition that people value a foreign currency only because, and to the extent that, it can command goods in its native country. When a person offers his own currency in exchange for a foreign currency, he is, in effect, offering to give up purchasing power over commodities at home in exchange for purchasing power over commodities abroad. His valuation of the foreign currency in terms of his own rests, therefore, primarily upon the relative purchasing power of each currency in its own country. Thus, if two currencies have equal purchasing power in their respective countries, their values on the foreign exchange market should be equal; for if they were not, persons in the country of the overvalued currency would find it to their advantage to increase their purchases from the country of the undervalued currency, until the demand in the former for the currency of the latter (to pay for the increased imports) raised the exchange value of the undervalued currency to equality. Unless the ratio at which two currencies exchange for each other is equal to the ratio between their domestic purchasing powers, therefore, forces are set in operation which eventually restore the identity of the two ratios. The ratio between the internal purchasing powers of two currencies is their purchasing-power parity, and, according to the theory, it is this ratio, or parity, which fundamentally determines the exchange rate.

Any alteration in the relationship of the price levels of the two countries must cause a corresponding alteration in purchasing-

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It was clearly stated as early as 1803 by John Wheatley in the discussions of disordered exchanges during the Napoleonic Wars. Professor Cassel may be said to have revived it. See James W. Angell, *The Theory of International Prices*, pp. 50-53.

## 188 International Trade and Commercial Policy

power parity and exchange rates. Any change in exchange rates not caused by a changed price-level relationship tends to be eliminated by the altered currents of trade which altered exchange rates set up. Purchasing-power parity is, in short, a norm toward which the exchange rate inevitably gravitates.

An example will help to understand how exchange rates tend to gravitate toward purchasing-power parity. Suppose that both the United States and Great Britain have inconvertible paper currencies, that price ratios are identical in the two countries, also that in the United States \$1,000,000 will buy one unit each of every commodity traded, whereas in Great Britain £200,000 will purchase a similar group of commodities. This means, ignoring transport costs and import duties, that \$5 has the same purchasing power in the United States that £1 has in Great Britain. Purchasing-power parity is, then,  $\$5 = \pounds 1$ . An exchange rate of  $\$5 = \pounds 1$  is an equilibrium rate, and in equilibrium, in our illustration, no trade takes place between the two countries. Suppose, now, that in Great Britain prices rise so that it takes £250,000 to purchase the list of commodities, while prices in the United States remain unchanged. Britons will cease buying domestic goods and will buy American goods, because the latter are cheaper. But this will force the price of dollars in Great Britain to rise to the new purchasing-power parity of  $\$4 = \pounds 1$ . At this rate, equilibrium will again be established, and trade will cease. If, on the other hand, no change should occur in the price level of either country, but the rate of exchange should fall to  $\$4 = \pounds 1$ , Americans would purchase British instead of domestic goods, for they could buy for \$4 in Britain what it would cost \$5 to buy at home. This would cause the dollar rate for sterling to rise, however, and the rate would continue to rise until it reached purchasing-power parity,  $\$5 = \pounds 1$ . At this rate equilibrium would be reestablished, and trade would cease.

This illustration obviously oversimplifies the facts. Price (cost) ratios in different countries do differ, and it is these variations in price ratios which form the very foundation of international trade. An equilibrium rate of exchange is not one at which there is no trade; it is one at which exports equal imports. In any case, purchasing-power parities calculated from general price levels are theoretically untenable, because it is normal for different countries to

have divergent, not equal, price levels, even under the gold standard when the prices of different nations are compared at the mint par of exchange. During the period of relative stability preceding World War I, for example, the price level of the United States was higher than that of England, that of England higher than that of Germany, and that of Germany higher than that of Italy.<sup>5</sup> In other words, it is not uncommon to find a durable international equilibrium even though exchange rates deviate from purchasing-power parities.

The causes of divergences among national price levels are manifold. One nation may have a higher price level than another because it imposes high import duties, import quotas, or prohibitions, or because its inward transport costs are greater than those of the other. A capital-importing nation will tend to have a higher price level than a capital-exporting nation, although this is not always true. The general price level of a nation may also be high if labor effectiveness in the domestic industries lags considerably behind that in the export industries, so that prices of strictly domestic goods are high.

The pitfalls of calculating purchasing-power parities from absolute price levels at any given date are so obvious that they are no longer calculated from such bases. Instead, calculations of purchasing-power parities are based upon *changes* in price levels from some date when international price relationships are considered to have been normal, usually a date when the gold standard has already been in operation for some time. Purchasing-power parities are now computed by multiplying the rate of exchange in this base period by the ratio of the price indexes for the two countries at the date for which the purchasing-power par is to be calculated.

The concept may again be clarified by an illustration. If the mint par of exchange between the United States and Great Britain in 1913, £1 = \$4.86, be considered an equilibrium rate for that year, price levels in that year are taken as the base price levels (index number = 100). Assume, now, that in 1920 each country has an inconvertible paper currency, and that prices in the

<sup>5</sup> J. H. Williams, "Foreign Exchange, Prices and International Trade," *Annals of the American Academy of Political and Social Science*, Vol. LXXXIX (May, 1920), p. 202.



## 190 International Trade and Commercial Policy

United States have doubled since 1913 while those in Great Britain have quadrupled. Purchasing-power parity for 1920 will then be  $\frac{\$4.86}{\pounds 1} \times \frac{200}{400} = \frac{\$2.43}{\pounds 1}$ . If, instead, United States prices had doubled while British prices had not changed, purchasing-power parity would then be  $\frac{\$4.86}{\pounds 1} \times \frac{200}{100} = \frac{\$9.72}{\pounds 1}$ . Clearly, purchasing-power parity is not a stable par, but varies with relative price-level changes.

### WEAKNESSES OF THE PURCHASING-POWER PARITY DOCTRINE

Purchasing-power parities thus calculated are, it must be emphasized, no more than norms toward which actual exchange rates tend to gravitate. While day-to-day rates may deviate from these parities, however, they cannot, it is contended, permanently remain far from them. Disturbances which cause deviations of actual rates from purchasing-power parities will not, according to Professor Cassel, endure for long, and permanent alterations in the level of the exchanges can come only from a prior change in the price parity itself.

Actually, however, deviations of exchange rates from parities based upon changes in the relationships of national price levels may be more than temporary; they may be the result of basic economic changes. Where this is true, the purchasing-power parity is no longer a true equilibrium rate, and may for an indefinite time, and even permanently, diverge from the true equilibrium rate. These deep-seated forces which cause the true equilibrium rate of exchange to diverge from purchasing-power parity are several.

(1) The demand for a foreign currency is not the demand for goods in general in the foreign country but for only certain goods, namely, those which can be exported. Since domestic goods do not move in international trade, changes in their prices obviously do not influence the total value of the nation's exports nor, consequently, the supply of, or demand for, the currency of the nation in the foreign exchange markets. The validity of the theory of purchasing-power parity rests upon the assumption that, when the price level changes, the prices of all goods change in the same direction and to the same degree. But this assumption is contrary to

experience. A general rise, or fall, of prices is always accompanied by an unequal movement of specific prices, some rising (or falling) more than others, and some even moving against the general trend. Prices of export goods may move in harmony with the general average, or they may not. To the extent that costs and prices of important export goods move differently from the general price index, purchasing-power parity calculated upon the general index will not represent an equilibrium rate.

Let us consider, for example, a country whose principal exports are cereals and whose general price index has advanced 25 per cent. If improved methods of producing cereals have been developed, it is quite possible that cereal prices have remained unchanged, despite the general price advance. But, as long as the prices of export commodities do not change, the equilibrium rate of exchange will remain unaltered, barring disturbances from some other source, even though purchasing-power parity computed on the *general* price index has changed. The relative importance of different commodities in the general price index may be quite different from their relative importance in foreign trade.

It might appear that this difficulty could be circumvented by calculating purchasing-power parity not upon an index of general prices but upon one which includes only the prices of goods which enter into international trade. A parity thus calculated would, however, be an empty truism. For the prices of goods which move freely in international trade differ in national markets only by the costs of transport plus import duties. Barring changes in transport costs and import duties, then, the prices of international goods in different national markets tend to change simultaneously and in the same way; the relative prices of such goods in different countries are the result of changes in exchange rates, as well as a cause of rate changes. Consequently, parities so calculated cannot be an independent norm to which exchange rates tend to conform; they must always show that existing rates of exchange are the true equilibrium rates.

(2) The foreign demand for a nation's currency, and hence the exchange rate, depends not only upon the supply prices of its exports but upon the *volume* of exports as well. If the foreign demand for a nation's exports is inelastic, a rise in the supply prices of its

## 192 International Trade and Commercial Policy

products will cause an increase in the *value* of its exports and consequently an *increase* in the demand for its currency and a rise in its external value, not a fall, as would be indicated by the purchasing-power parity theory. Again, if the foreign demand for its exports has a unitary elasticity, a rise in the supply prices of its products will not alter the value of its exports and will not, of course, affect the external value of its currency, despite the fall indicated by purchasing-power parity. Only if the foreign demand for its products is elastic, will there be a decline in the total value of its exports. And even then, the extent of the depreciation of its currency will depend upon the elasticity of the foreign demand for its exports and the elasticity of its demand for foreign exports, rather than upon the extent of the rise in general prices. There is no reason to expect that the new equilibrium rate will equal purchasing-power parity; it may be above or below the parity rate.<sup>6</sup>

(3) The justification for calculating purchasing-power parity on some given base period is the assumption that the rate of exchange existing in the base period is normal for the national price levels of that base period, as well as for the later period. Although it is obviously normal for different countries to have divergent price levels, it holds true, nevertheless, that exchange rates in the base period have taken these divergencies into account and are true equilibrium rates. But to infer from this that exchange rates for some later period calculated upon relative price level changes between the base period and the later period are normal, or equilibrium, rates for the

<sup>6</sup> Suppose, for example, that the United States and Canada each export to the other 1,000,000 units of goods at \$1.00 per unit, and that in equilibrium \$1.00 U.S. = \$1.00 Canada. Suppose now that the American price level rises to 150, all goods in the index rising equally, while Canadian prices remain unchanged, and that at the higher price of \$1.50 Canadians buy only 600,000 units of American exports, a total value of \$900,000. The decline in the total value of American exports will cause Canadian currency to rise in terms of United States currency. The rise in the rate of Canadian currency, however, means to Americans an increase in the cost to them of Canadian goods, and at the higher prices they will buy fewer Canadian goods. It may very well happen that when the exchange rate reaches, say, \$1.00 C. = \$1.11½ U.S., the American demand for Canadian goods will be cut down to 810,000 units, at a total cost to Americans of \$900,000. But, since at this point the total value of exports equals the total value of imports, the rate of \$1.11½ is the equilibrium rate. Note, however, that while the equilibrium rate is \$1.11½, the purchasing-power parity is \$1.50.

later period assumes that all of the conditions which have produced divergent price levels in the base period remain unchanged in the later period. Such an assumption is unwarranted, especially as the base period becomes more remote. Between the base period and the given period tariffs will be altered, costs of transport will rise or fall, and not uniformly, demands will change, new products will appear and the efficiency of producing old ones will change in the various nations, and the international flow of capital will alter, in both quantities and directions. Even under practically constant exchange rates, such as prevail under the gold standard, the operation of these forces, which at any given time produce a certain pattern of price level relationships among different countries, may necessitate, over a period of time, an entirely different pattern. In fact, under the gold standard adjustment to such changes typically occurs, in part, through changes in national price levels. Under inconvertible currencies, adjustment operates through changes in exchange rates, independent of price level changes, and to that extent vitiates conclusions and predictions which are based on a previous price level-exchange rate relationship. Purchasing-power parity thus becomes merely the innocuous declaration that if everything else remains unchanged, price level relationships determine exchange rates.<sup>7</sup>

(4) Many items besides merchandise go to make up the balance of international payments and thus directly affect exchange rates, items which are little, if at all, affected by changes in commodity price levels. Among these are movements of capital, interest and dividend payments, immigrant remittances, indemnity payments, payments for banking and insurance services, and expenditures of tourists. Changes in one, or several, of these items between two periods may overbalance changes in price levels and commodity movements, so that exchange rates move quite differently from ex-

<sup>7</sup> This weakness has been admitted by Professor Cassel. He states, "In doing so (calculating par after a period of currency depreciation), to be exact, we must presuppose that no other changes have taken place. If in each country prices are unaltered in their relation to one another, but have only undergone a common rise, then there is nothing to prevent our supposing the balance of trade between countries to be unaltered." From Gustav Cassel, *Money and Foreign Exchange After 1914*, New York, 1927, p. 141. By permission of The Macmillan Company, publishers.

## 194 International Trade and Commercial Policy

pectations based upon price levels and purchasing-power parity. A nation which may have been an international borrower in the base year, for example, may later become an international lender, exporting year after year large amounts of capital.<sup>8</sup> These capital exports will tend to lower the value of its currency in terms of foreign currencies. At the same time, its price level may have fallen relative to other national price levels, a situation entirely possible, so that the purchasing-power parity of its currency will have risen. Thus, the equilibrium exchange rate will move in a direction the very reverse of that indicated by movements of commodity price levels. Exchange rates, in other words, are determined by *all* the debit and credit items in the balance of payments, not just by commodity items, which alone are particularly responsive to changes in general price levels. How exchange rates may, and do, depart from purchasing power parity is shown in Table 4.

One final criticism of the purchasing-power parity doctrine must be made. The doctrine not only asserts that exchange rates and price parities tend to rise, or fall, together, but it also undertakes to establish a causal relationship between them. It holds that changes in general prices, and therefore in price parities, will be substantially proportional to changes in the volume of money (including deposits, of course) in circulation. Exchange rates are, therefore, basically governed by the relative degrees of inflation, or deflation, in the various countries. In brief, changes in the quantity of money in circulation affect general price levels, and changes in general price levels, in turn, affect the foreign exchanges and purchasing-power parities.

Now while it is true that price-level changes cause alterations in exchange rates and price parities, the history of severe depreciations in the years after the first World War shows conclusively that the actual sequence of events may be the exact opposite of that predicated by the theory. The initial change has frequently been the collapse of the foreign exchanges. This has been followed by a rise in internal prices, and eventually by an increase in the quantity of money in circulation.

Professor J. H. Williams has found that the source of the collapse of the German currency in 1921 was neither excessive paper money

<sup>8</sup> The United States underwent such a transformation between 1914 and 1920.

## International-Payments Equilibrium 195

issues nor budget deficits, but rather pressure against the balance of international payments.<sup>9</sup> Attempts by the German government to transfer large reparations payments to the Allied governments caused a sharp depreciation in the foreign exchange value of the

TABLE 4. Ratios of Purchasing-Power Parities<sup>a</sup> to Actual Exchange Rates of Six European Inconvertible Paper Currencies in Terms of the Dollar: 1919-1923

Date	Sweden	Nether-lands	Great Britain	France	Italy	Germany
<b>1919</b>						
Jan.			90.7	60.1	75.2	148.2
Apr.			95.7	69.3	85.4	208.4
July			95.9	81.5	95.7	224.4
Oct.			93.0	91.7	107.7	241.0
<b>1920</b>						
Jan.	88.2	86.3	107.0	108.8	114.4	260.4
Apr.	80.7	90.9	96.9	128.6	159.6	222.8
July	78.3	93.6	101.5	115.3	133.2	165.6
Oct.	80.2	97.1	104.8	124.2	156.9	231.1
<b>1921</b>						
Jan.	78.2	97.6	95.3	125.4	143.9	175.6
Apr.	70.5	97.3	92.1	113.7	106.3	168.8
July	83.3	100.1	101.6	105.5	115.5	180.8
Oct.	85.4	101.0	109.5	114.2	115.1	201.5
<b>1922</b>						
Jan.	81.9	92.8	101.9	103.9	105.5	173.1
Apr.	83.7	93.0	99.8	95.1	97.4	154.3
July	92.3	98.0	108.1	111.7	117.3	180.0
Oct.	91.6	102.5	110.3	119.7	118.5	200.0
<b>1923</b>						
Jan.	95.3	101.0	106.6	116.5	107.2	190.6
Apr.	95.0	104.6	105.9	110.8	105.2	181.6
July	93.6	106.7	109.1	121.6	118.9	160.3
Oct.	96.4	106.2	109.7	117.8	116.2	

Source: F. D. Graham, *Exchange, Prices and Production in Hyperinflation: Germany, 1920-1923*, Princeton University Press, Princeton, 1930, pp. 118-120.

<sup>a</sup> Purchasing-power parities are based on the year 1913.

mark. The depreciation of the mark brought an automatic rise in import prices and a somewhat more gradual rise in export prices, followed by a rise in the prices of domestic goods.<sup>10</sup> Since tax

<sup>9</sup> "German Foreign Trade and the Reparations Payments," *Quarterly Journal of Economics*, Vol. XXXVII (1922), pp. 487 ff.

<sup>10</sup> Since many German raw materials are imported, a rise in the prices of imported goods raises the costs of domestic goods. Higher prices for export

## 196 International Trade and Commercial Policy

revenues could not keep pace with the rise in prices, budgetary deficits resulted. The government was, therefore, compelled to discount bills at the Reichsbank, and thus brought about an expansion of bank deposits and bank notes. Business firms were also obliged to resort to additional bank borrowing in order to maintain operations in the face of rising prices. Professor Williams also cites conditions in Argentina from 1883 to 1888 to show that the balance of payments often governs the foreign exchanges and the domestic value of the currency.<sup>11</sup>

One of the most common sources of pressure against a nation's balance of payments during periods of disorganized currencies has been speculation. The failure of a nation to balance its budget, a situation brought about in the postwar years by the existence of war debts, both internal and external, undermines popular faith in the future of the currency and precipitates a flight of capital. Foreigners who have claims against the debt-ridden country hasten to dispose of these claims, while nationals who possess liquid assets hurry to transfer their wealth to countries with more stable currencies. The greater the prospect of further depreciation, the stronger the bear tendency becomes. Under a regime of severe and rapidly growing depreciation, speculation is one of the most important factors in the short-term movements of prices and the foreign exchanges. The late Professor Allyn A. Young concluded that the characteristic sequence of events in postwar Europe was not inflation, unbalanced budgets, disordered exchanges, but, rather, unbalanced budgets, disordered exchanges, and inflation.<sup>12</sup> Unbalanced budgets dissipate public confidence in the future of a currency, and thus cause a flight of capital and speculation against the currency in the foreign exchange market. Not until the French gov-

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goods tend to raise the rewards of the productive factors in the export industries, and, since many of these factors are also employed in purely domestic industries, these higher costs are transmitted to the latter.

<sup>11</sup> "Foreign Exchange Under Depreciated Paper," *Journal of the American Bankers' Association*, Vol. XIV (1922), pp. 493, 494. Cited by J. W. Angell, *The Theory of International Prices*, p. 193.

<sup>12</sup> "War Debts, External and Internal," *Foreign Affairs*, Vol. II (1924), especially pp. 402-405. See also Angell, *op. cit.*, pp. 195-198. Speculation may, at times, provide support for a currency. Individuals who believe that the exchange rate must eventually return to mint par, or rise toward par, consider a currency a bargain as it drops below parity.

ernment finally succeeded in balancing the state budget in 1926 was it able to stabilize the exchange value of the franc.

What, then, remains of the doctrine of purchasing-power parity? Is it of no value? Admittedly, it is useless for explaining or predicting day-to-day fluctuations in foreign exchange rates; even its most ardent supporters do not claim this for it. But the preceding discussion has shown that it also fails to explain the true norm about which day-to-day rates fluctuate. Purchasing-power parity indicates only what exchange rates should be *in the absence of any disturbing elements other than price-level changes*. Foreign exchange rates are, however, the resultant of *all* the forces represented in the balance of payments, and these, in turn, are shaped by the whole complex of economic life. No theory of the exchanges which fails to include every important element in the problem can be considered satisfactory.

Nevertheless, the doctrine of purchasing-power parity does have a limited usefulness. In periods of severe inflation, when fluctuations in general prices predominate over all other economic disturbances, it may afford a rough approximation to the true equilibrium rate of exchange. And certainly, during the period of extreme inflation after the first World War, it did much to warn men of the futility and danger of attempting to return to the prewar gold parities and to urge them to seek for *true* equilibrium rates. The theory also shows the futility of seeking any permanent advantages from depreciating a currency below its equilibrium value. For strictly monetary changes, the theory possesses considerable validity.

### THE EQUILIBRIUM RATE OF EXCHANGE

The nature of the equilibrium rate of exchange has already been indicated. It is, briefly, that rate which establishes a stable equilibrium in the balance of payments. This means not merely that the credits and debits of the international accounts balance, but also that all the basic forces which affect the international accounts—commodity prices, factor prices, costs of services, the flow of international lending, etc.—are brought into a stable equipoise. A change in any of the underlying basic conditions<sup>13</sup> will disturb the existing equilibrium, destroy the equilibrating effects of the existing ex-

<sup>13</sup> Not offset by other counteracting changes.



## 198 International Trade and Commercial Policy

change rate, and set in operation forces which establish a new, and different, equilibrium rate of exchange. An analysis of the mechanism by which international-payments disequilibria are adjusted under inconvertible paper currencies will emphasize the meaning and significance of an equilibrium rate of exchange.<sup>14</sup>

### THE ADJUSTMENT OF DISEQUILIBRIA

Under gold standard conditions, the establishment of a new international-payments equilibrium, once a former state of equilibrium has been disrupted, necessitates an alteration in the international flow of goods and services; and this alteration in the flow of goods and services is brought about by a transfer of purchasing power, a rise, or fall, in money incomes, and a probable rise, or fall, in prices. The increase in bank deposits or bank notes (which makes possible the increase in money incomes) in the country with the active balance of payments rests upon the willingness of its bankers to increase their foreign balances (i.e., to export short-term capital), and/or their ability to convert currency into gold, and gold into currency, at fixed prices in the various countries.<sup>15</sup> The readiness of bankers to hold and increase their balances abroad and to borrow and lend on short-term abroad is predicated upon the stability of foreign exchange rates. Now stability of exchange rates is the basic feature of the international gold standard, for where currencies are freely convertible into gold at fixed prices rate fluctuations are restricted within the narrow confines of the gold points. Under the gold standard, consequently, short-term capital is highly mobile. If adjusting movements of short-term capital fail to provide a sufficient transfer of purchasing power, then the deficit may be filled by a flow of gold.

But if bankers become unwilling to acquire foreign balances, and if currencies are no longer convertible into gold, international transfers of purchasing power are not possible, and adjustments of international disequilibria by means of an expansion (and contrac-

<sup>14</sup> A stimulating discussion of equilibrium exchange rates is given by Frank M. Tamagna in "The Fixing of Foreign Exchange Rates," *Journal of Political Economy*, Vol. LIII (March, 1945), pp. 57-72.

<sup>15</sup> Also, deposits may pass from the financial to the industrial circulation if foreign banks possess balances in the country.

tion) of money incomes cannot take place. An increase in the supply of, or demand for, foreign currencies can then only cause a sharp fall, or rise, in exchange rates until purchasers of foreign goods and services (or foreign purchasers of domestic goods and services) are induced to expand their purchases to an extent sufficient to absorb the increased offerings of currency. When currencies are inconvertible, exchange rate fluctuations are no longer limited by the gold points; instead, rate movements tend to be frequent, unpredictable, and wide. The risk of variations in exchange rates then becomes so great as virtually to eliminate short-term capital movements of the adjusting type.<sup>16</sup> With currencies inconvertible, furthermore, gold becomes an ordinary article of commerce, like wheat or iron, so that transfers of purchasing power by means of gold shipments must be ruled out.<sup>17</sup> Since it is impossible to transfer purchasing power from country to country, disturbances of equilibrium can only result in a rise or fall in exchange rates, and it is by such changes alone that the adjustment to a new equilibrium position can be brought about. The general nature of the adjustments which take place under independent paper currencies can best be described by considering a specific case of disturbance.<sup>18</sup>

Assume that both the United States and England have inconvertible paper currencies, and that with the rate of exchange £1 = \$4 their international accounts are in equilibrium. Assume further that the equilibrium is suddenly disrupted by the extension of large annual loans by England to the United States, the loans to continue over many years. This sudden offering of an enlarged supply of sterling bills in the United States will drive down the sterling rate in this country, and, since the demand for sterling in

<sup>16</sup> It has been pointed out in Footnote 2 (p. 186) that some short-term capital movements of an adjusting nature do take place when currencies are divorced from gold.

<sup>17</sup> Where gold is still used in the settlement of international balances, its price in terms of paper currencies will be variable and exchange rates will be subject to wide variations. Management by the monetary authorities may, however, succeed in maintaining exchange rates stable over considerable periods of time, even though the currency is inconvertible. This point is discussed below, pp. 202-203.

<sup>18</sup> The outlines of the adjustment have already been drawn in Ch. VII.

## 200 International Trade and Commercial Policy

the very short run will be inelastic, the decline in the rate will be considerable, say to  $\text{£}1 = \$3$ .<sup>19</sup> The fall in the sterling rate causes a decline in the American prices of English goods and a rise in the English prices of American goods, so that American exports are reduced and American imports increased. Equilibrium will be restored when the commodity flow has been altered to such an extent that the United States develops an import balance of trade (and England an export balance) exactly equal to the annual borrowings.

Where English exporters have been quoting prices in terms of sterling, the drop in the dollar-sterling rate to  $\$3$  automatically lowers the prices of English goods to Americans by 25 per cent. Where, on the other hand, English exporters have been quoting their prices in dollars, they will receive windfall profits, which an expansion of production and new entries will tend eventually to eliminate, at least in part, by forcing reductions in prices.<sup>20</sup> If American exporters have been quoting prices in dollars, the rise in the sterling price of dollars means an automatic increase of 33½ per cent in the prices of American goods to Englishmen. If, on the other hand, they have been quoting their prices in sterling, the drop in the dollar-sterling rate to  $\$3$  will cause them windfall losses, which, in turn, will result in a contraction of output.<sup>21</sup>

The initial impact rate of  $\$3$  will not be the long-term equilibrium rate. As the international flow of goods is altered and the American demand for sterling increases, the rate will be driven up again. The equilibrium rate will lie somewhere between the initial impact rate ( $\$3$ ) and the old equilibrium rate ( $\$4$ ), depending upon the reciprocal demand. The more elastic the American demand for

<sup>19</sup> The chief source of elasticity in the demand for foreign exchange, viz., short-term capital movements, is ruled out, and the demand for merchandise imports becomes the chief source of elasticity. But, even though prices of imports fall immediately, some time must elapse before importers place new orders and enter the foreign exchange market as purchasers of sterling.

<sup>20</sup> Obviously, the speed and degree of the price reductions will hinge upon the readiness with, and the extent to, which factors of production may be shifted into the export industries, either from unemployment or from the domestic industries.

<sup>21</sup> Those American industries which export but a small fraction of their outputs and for whose products domestic demand is elastic will be forced to undergo but little reduction in outputs, and prices of their products will not fall much. Those operating under conditions of very imperfect competition will tend to maintain price and contract output.

English products and the English demand for American products, the closer to the old equilibrium rate will the new equilibrium rate lie: conversely, the more inelastic the demand of each for the products of the other, the closer will it lie to the initial impact rate. For a drop in the sterling rate means a fall in the prices of English goods to Americans and a rise in the prices of American goods to Englishmen. With both demands very elastic, therefore, only a relatively small decline in sterling will bring a large increase in American purchases of English goods and a large decline in English purchases of American goods.<sup>22</sup>

A shift in the distribution of productive factors will take place in both countries. The depressed export and import-competing industries in the United States will suffer contraction, to a greater or lesser extent, while the domestic industries will expand, under the stimulus of new investment, and absorb unemployed factors and factors released by the depressed export- and import-competing industries. In England, the shift will be in the opposite direction. The prosperous export and import-competing industries will attract more production factors, from unemployment (if any) and from the domestic industries. Activity in the latter will tend to suffer somewhat from the diversion of capital from home investment to foreign investment.

Changes in relative prices in the two countries will also occur. Import prices in the United States will be lower than formerly, in England higher. In the United States, prices of export goods and import-competing goods will tend to fall at first, and, if factors are relatively immobile, prices may remain low for a considerable period. But, as production is curtailed, prices will rise toward their previous levels; the ultimate levels reached will depend upon whether the particular industry operates under constant or increasing costs.<sup>23</sup> Domestic price changes will depend on whether output expansion encounters constant, increasing, or decreasing costs, and also on how elastic the supplies of the factors of production are. In

<sup>22</sup> A sharp drop in sterling is likely to bring speculative pressure against sterling, which will push the rate close to the impact rate. Note that any export of short-term capital from England under these circumstances is speculative in nature, not adjusting.

<sup>23</sup> Industries characterized by imperfect competition may resist even an initial price decline.

## 202 International Trade and Commercial Policy

England, prices of export and import-competing goods will tend to rise at first, but will fall as output is gradually expanded. The ultimate prices will depend upon the nature of the costs encountered in each industry (increasing, decreasing, or constant) and the elasticity of factor supplies. Domestic prices will be affected by shifts in demand, the nature of costs in each industry, the mobility of productive factors, and whether pure or imperfect competition rules the industry.

It can now be seen that under either the gold standard or inconvertible paper currencies large international loans are transmitted in the same basic way, namely, through an expansion of the exports of the lending country and a curtailment of the exports of the borrowing country. Once the fundamental adjustments have been made, the loans may continue year after year without further changes in prices or in the rate of exchange. But the mechanism of adjustment differs in the two cases. In the case of the gold standard, an international transfer of purchasing power produces income and price changes in the respective countries, and these lead to an altered international flow of goods. In the case of inconvertible paper currencies, no international transfer of purchasing power takes place and national money incomes do not change; the altered flow of goods is induced solely by wide variations in the rate of foreign exchange. In the borrowing country, the funds acquired by the borrowers are furnished by the importers and are made available by the increased foreign purchases of importers. In the lending country, the funds furnished by lenders go to pay exporters for the increased exports to the borrowing country and the import-competing industries for their added domestic sales. Although total money incomes in the borrowing country do not expand, the borrowing country nevertheless gains from the loans. Its terms of trade improve; it acquires exports of the lending country at a lower unit cost in terms of its own exports than formerly, since the prices of imports have fallen.

*Stable Exchange Rates.* In our discussion of exchange rates under inconvertible paper currencies, it has been assumed that rates are subject to wide, frequent, and unpredictable fluctuations so that financial and speculative movements of short-term funds are deterred by the excessive risks of exchange. While this assumption is

true of many situations, it is not true of all. In some circumstances, exchange rates even under inconvertible paper currencies remain stable for considerable periods of time. The central bank or an exchange-stabilization fund operated by some government agency may undertake to stabilize the foreign exchange value of the country's currency in relation to the currency of some other country. This can be done by standing ready to buy, or sell, any quantity of the foreign currency offered, or demanded, at fixed prices, equivalent to the gold points.<sup>24</sup> When bankers become convinced of the ability and intention of the exchange authorities to maintain stable exchange rates over a period of time, they will be willing to accumulate foreign balances and to borrow and lend abroad. When bankers are thus willing to indulge in short-term capital transfers, international transfers of purchasing can be made.

Where stability of exchange rates permits short-term capital movements of an adjusting nature, a disturbance of international equilibrium produces a transfer of purchasing power, and the adjustment of the balance of payments tends to follow the same lines as under the gold standard. In the country experiencing the favorable turn in its balance of payments, there will occur an expansion of the money supply and an increase in incomes, while in the country in whose international balance a deficit appears there will occur a contraction of the money supply and a decline in incomes. These shifts in incomes will cause an alteration in the direction of international expenditures, which, in turn, will affect the more elastic items in the balance of payments and restore international equilibrium. Prices of export, import, and domestic goods will change relative to one another, and some reallocation of factors among the different types of industries will take place.<sup>25</sup>

<sup>24</sup> Great Britain established an exchange-stabilization fund in 1932, and the United States followed suit in 1934. In 1936 these two nations entered into a Tri-Partite Agreement with France whereby the three nations agreed to stabilize exchange rates among their three currencies. When Great Britain abandoned the gold standard in 1931, the Scandinavian countries, some of the Dominions, and several other countries—thirteen altogether—undertook to tie their currencies to the pound; parities with sterling were not rigidly fixed, as under the gold standard, but were permitted to shift somewhat as national interest seemed to dictate.

<sup>25</sup> See Professor Ellsworth's discussion of this situation, *International Economics*, pp. 256-258.

## EXCHANGE DEPRECIATION AND PRICE CHANGES

Once a country has abandoned the gold standard, exchange depreciation almost inevitably follows. The depreciation may be either involuntary or voluntary. When a country has been compelled to abandon gold because of an inexorable pressure upon its balance of payments, a situation brought about by its inability to adjust prices and incomes to a new equilibrium under fixed exchange rates, the external depreciation of its currency constitutes an adjusting movement toward the position necessary to bring the international accounts into equilibrium. Exchange depreciation is here the direct result of failure to bring domestic prices into line with world prices, at fixed exchange rates, and is the means of effecting the necessary adjustment.<sup>28</sup>

But countries sometimes *voluntarily* choose to depreciate their currencies. Prior to 1929, intentional depreciation of a country's currency was seldom attempted. Inflation, rather than deflation, was the bogeyman to be avoided, and in the public mind depreciation was synonymous with inflation. Pressure upon the balance of payments was, therefore, combatted with protective tariffs and internal deflationary measures. With the onset of depression in 1930, however, widespread and deepening deflation and unemployment created an atmosphere in which any measures that promised relief merited a trial—even the much feared exchange depreciation. Where a currency was overvalued, exchange depreciation promised ready relief from deflation. And if the external value of the country's currency were forced *below* its true equilibrium value, domestic recovery might be encouraged, for exports would be stimulated and imports penalized; both developments would give a fillip to domestic industry.

Voluntary depreciation may be accomplished in several ways. First, countries on the gold standard may depreciate their currencies by devaluation, i.e., by reducing the gold content of the monetary unit. Second, the central bank or the treasury may depress the value of the currency by entering the foreign exchange market and

<sup>28</sup> Panicky flights of capital may exhaust a country's gold reserve before adjustment hardly gets under way. The deflation of prices and costs to an equilibrium level may be prevented by political inexpediency and sticky costs, the latter resulting from powerful labor organization and monopolistic price policies.

buying foreign currencies at higher and higher prices. Finally, the very threat of internal inflation is likely to induce a flight of capital and speculation against the currency, and thus drive foreign exchange rates upward.

The first effect of abandoning gold is a sharp rise in foreign exchange rates, a rise which speculation will carry well above the equilibrium rates. Once the initial speculation has been checked, however, exchange rates should react to the equilibrium level. But the government may, by continuing to buy foreign currencies at the above-equilibrium rates, maintain indefinitely the undervaluation of its currency.<sup>27</sup> Since international equilibrium can, consequently, not be attained through the adjustment of exchange rates, it must come through changes in prices and costs. Any free movement of international trade then results in, and depends on, rising prices in countries of depreciated currencies, falling prices in other countries, or some combination of the two. To what extent equilibrium will be restored by a rise in prices and costs within the depreciated-currency country and to what extent by a fall in prices and costs in the outside world cannot be accurately forecast. Nevertheless, the conditions that operate in favor of or against an internal price rise can be indicated.

Exchange depreciation will tend to bring about a relatively great increase in prices in the country undergoing depreciation under the following conditions:<sup>28</sup>

- (1) when the foreign demand for the country's exports is elastic. The foreign demand for a given exportable commodity will tend to be elastic when the country supplies but a small part of the world trade in that commodity.
- (2) when the domestic demand for exportable goods is inelastic. A rise in export prices will then attract only small supplies from the domestic market.
- (3) when the home supply is relatively inelastic, and a rise in export prices will not be able to divert large supplies from the home market to foreign markets. Supply will be inelastic

<sup>27</sup> The same results will follow from an excessive devaluation, if gold is not abandoned, or by a chronic budget deficit; the latter is a constant threat of internal inflation.

<sup>28</sup> For this analysis I am indebted to Professor S. E. Harris. See his *Exchange Depreciation*, Harvard University Press, 1936, Ch. II.



## 206 International Trade and Commercial Policy

when any exportable commodity is produced largely for export, and only a small part of the supply is sold at home; also, when there are no excess capacity and no surplus stocks.

- (4) when supplies of identical exportable commodities are elastic in competing countries. Any tendency of world prices toward weakening as a result of exchange depreciation will then be met by a ready shrinkage of supplies from other sources.
- (5) when the number of countries simultaneously depreciating their currencies is small.
- (6) when the country depreciating its currency is small in size.
- (7) when a country is so dependent on its foreign trade that a large part of its domestic trade and prices is intimately affected by changes in import and export prices.

Where the opposite conditions hold, exchange depreciation will tend to depress prices abroad rather than raise internal prices. Furthermore, if stable-exchange countries meet exchange depreciation by other countries with tariff increases and import quotas, world prices will fall, since export markets will, as a consequence, be restricted. But not only will rising trade barriers by stable-exchange countries tend to depress world prices; they will also tend to check economic recovery, and to that extent offset the stimulation of currency depreciation in countries which have depreciated their currencies.

As a recovery measure and as a means of raising domestic prices, exchange depreciation may be expected to be more successful when employed by a small country than when employed by a large one. Foreign trade is apt to constitute a larger fraction of the total trade of small countries than of large ones, so that rising import and export prices will have a more direct effect upon domestic trade and factor prices in the former than in the latter.<sup>29</sup> Because the imports and exports of large countries have greater weight in world markets than those of small countries, there is greater likelihood that exchange depreciation by large countries will cause a fall in prices abroad than a rise in domestic prices and costs. Furthermore, exchange depreciation is more likely to invite retaliatory action in the form of counter-depreciation or trade restrictions on the part

<sup>29</sup> There are, of course, exceptions to this, e.g., Great Britain.

of other countries when it is undertaken by a large country than when it is the act of a small one. Either form of retaliation tends to curb economic recovery and the rise of prices.

The British depreciation of September, 1931, and the American depreciation of 1933–1934 offer some interesting evidence relative to the effects of exchange depreciation. The withdrawal of capital and speculation against the pound, which originally forced Britain off the gold standard, continued to drive the value of sterling down until by June, 1934, the sterling price of gold had risen to 162 (Sept., 1931=100). In the same period, British wholesale prices had risen to only 108, and the *Economist's* index of business activity had moved only from 96.1 in September, 1931, to 107.4 in May, 1934. The failure of British prices to rise to anything like the extent of the exchange depreciation is attributable, in large measure, to the deliberate depreciation of their currencies, practically simultaneously with the sterling depreciation, by those countries with which a considerable part of Britain's trade was carried on (the Sterling Bloc). It is also possible that the advance of depression throughout the world had resulted in a progressive overvaluation of the pound. If so, a large depreciation of sterling could have taken place without resulting in any overvaluation of the pound.

Unlike Great Britain, the United States was not forced to abandon the gold standard because of pressure upon its balance of payments. Depreciation and devaluation were, rather, deliberately chosen as a means to raise the domestic price level and stimulate business recovery. The appreciation of approximately 40 per cent in the dollar price of the French (gold) franc between March and August of 1933 was accompanied by a rise in American wholesale prices amounting to 20–25 per cent and by a sharp spurt in business activity. Although the dollar price of gold rose sharply to 169 in January, 1934, at which price it was stabilized, wholesale prices rose little thereafter to the end of 1935, and business actually suffered a reaction after August, 1933, which did not give way to substantial recovery until 1936. The failure of prices and business to respond to exchange depreciation after July, 1933, as they had in the March–July period, suggests that although the abandonment of the gold standard may have contributed to the upturn, other factors were probably more important contributors. After nearly four years

## 208 International Trade and Commercial Policy

of depression, the inauguration of a new President who promised to lead the nation to prosperity and the imposition of a firm control over a shaky banking system apparently provided the shock needed to cause a turn in general business activity. It seems probable, therefore, that the price rise that developed in the United States after March, 1933, was one phase of a general cyclical upswing in business, to which currency depreciation was only one of several contributing factors, and a relatively minor factor at that.

The failure of internal prices to rise during the 1930's to the extent which might have been expected from the degree of exchange depreciation may be accounted for on four grounds: (1) the prior overvaluation of the currency; (2) special price concessions to buyers in depreciated-currency countries by exporters in stable-exchange countries; (3) the increasing proportion of trade carried on by depreciated-currency countries with other depreciated-currency countries; and (4) the fact that adjustment to the new exchange rates took place more through a fall in prices in stable-exchange countries than through a rise in prices in depreciated-currency countries.

Exchange depreciation appears to have freed countries adopting it from the declining price trends in the gold standard world, and to have given them some competitive advantages where depreciation was carried to the point of undervaluation. At the same time, it appears to have accentuated the deflationary pressure on gold standard countries. These conclusions are supported by the facts depicted in Figure 2. From 1929 to September, 1931, when England abandoned gold, the price levels of England, France, Japan, and the United States all moved downward by 25-30 per cent. British prices ended their decline as soon as she cut loose from gold, and thereafter tended to rise slightly. The same is true of prices in Japan, which permitted the yen to depreciate with sterling. Prices in France and the United States continued to decline, however. The decline in the United States was halted only when she abandoned the gold standard in 1933; the decline in France was not halted until 1935, when devaluation appeared inevitable.

Professor Harris, in his outstanding work on exchange depreciation,<sup>30</sup> concludes that exchange depreciation is most likely to cause

<sup>30</sup> *Op. cit.*, pp. 475, 483.

a rise in internal prices when it is accompanied by the proper domestic policies: low money rates, credit expansion, government spending and unbalanced budgets, and specific price-raising policies. He attributes the relatively greater rise in prices in the United States than in England, following their respective depreciations, to

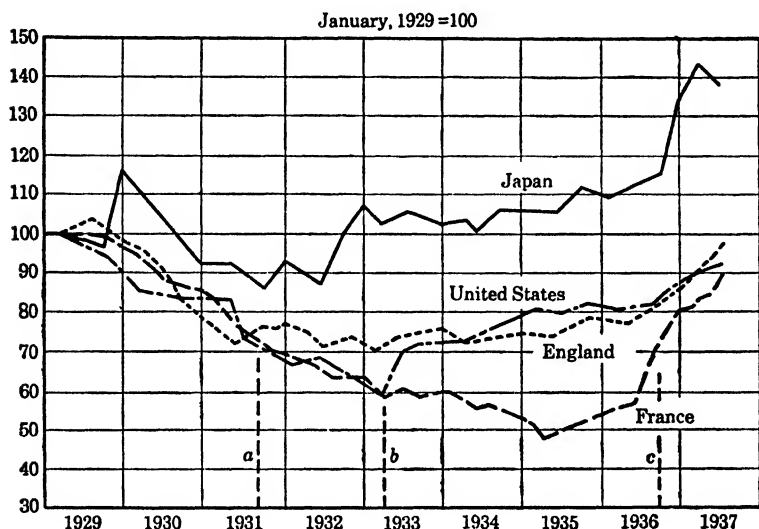


FIGURE 2. Wholesale Prices in England, France, Japan, and the United States, 1929-1937.

*a*, England abandoned gold; *b*, the United States abandoned gold; *c*, France devalued. (Based on data compiled by the League of Nations and published in the *Statistical Yearbook* and the *Monthly Bulletin of Statistics*.)

the easy money policies, the unrestrained public spending, the Agricultural Adjustment Act, the National Industrial Recovery Act, and other policies which tended to raise wages adopted in the former country. When exchange depreciation is accompanied by these supplementary policies, there is a greater likelihood that it will contribute towards higher prices in national markets and, therefore, towards a smaller decline in world markets, than would be true in the absence of such policies.

In evaluating the broad effects of exchange depreciation over the period 1931-1935, Professor Harris judges that depreciation did

## 210 International Trade and Commercial Policy

the world more good than harm, that it helped rather than hampered recovery. From this it is not to be inferred that under all circumstances exchange depreciation must be deemed a desirable policy, nor that exchange instability, if continued for long periods, may not have undesirable results and actually impede substantial economic recovery. But when the world is in the throes of cumulative business contraction and deflation, and the world economic system is beset with price rigidities, depreciation seems a quicker and less painful means of halting world depression than deflation.

TABLE 5. Production and Exchange Depreciation in Selected Countries, 1931-1935

Ratio of:	U.S.A.	U.K.	France	Germany	Japan	Italy	Chile
PRODUCTION (Per cent of 1929 and 1931)							
1931 to 1929	68.0	83.8	89.2	73.3	91.8	77.5	77.8
1932 to 1931	79.0	99.5	77.5	83.1	106.8	86.2	111.7
1933 to 1931	93.8	105.1	86.5	93.6	123.5	95.0	123.0
1934 to 1931	97.6	117.8	80.0	116.6	140.5	104.2	135.0
1932-34 to 1931	90.0	107.5	81.3	99.0	123.5	95.1	123.1
1935 to 1931	110.0	124.3	74.4	138.7	152.8	118.7	154.0
EXCHANGE DEPRECIATION (Per cent of par)							
1931	.05	6.91	0.0	.80	2.00	1.08	27.78
1932	.25	28.19	0.0	.30	43.60	2.62	72.10
1933	19.41	31.90	0.0	.36	59.65	1.03	79.63
1934	40.33	38.23	0.0	1.41	64.44	2.98	80.26
1932-34	20.01	32.77	0.0	.69	55.90	2.21	62.34
1935	40.60	40.20	0.0	.30	65.80	7.00	79.90

Source: League of Nations Publications, *Monthly Bulletin of Statistics*, 1935, Tables I, 14 (d), B (in No. IV). Reprinted in Harris, *op. cit.*, p. 174.

Not only did the decline in prices come to an end and prices actually rise with depreciation in those countries which abandoned gold, but those countries also experienced an expansion in trade and production as well. From 1931 to 1935, countries not on the gold standard made large gains in production as compared with those which struggled to maintain their predepression parities. This fact is convincingly shown by the figures in Table 5.

The degree of recovery in production in Chile, Japan, and the United Kingdom, countries with a large degree of exchange depre-

ciation, stands in marked contrast to the continued depression in France, a country which remained on gold and, until 1936, refused to devalue its currency.<sup>81</sup>

The gains in production by countries which depreciated their currencies were more largely the results of expansion in the home market than the capture of a larger share of foreign markets. Exchange depreciation seems to help more by improving the cost-price relationships at home than by capturing foreign trade at the expense of rivals. The traditional lag of wages and certain other costs behind prices in periods when prices are rising produces larger profits, which are, in turn, an inducement to new investment and improvement in general business. As is to be expected, exchange depreciation tends to make export and import-competing industries relatively more profitable. But when it is followed by the creation of extreme trade barriers, so that prices of international commodities are falling relative to those of other commodities, the incentive for a relative expansion of export and import-competing industries may be lacking.

Countries which abandoned gold also captured a larger share of world trade. Furthermore, as depreciation spread, not only was the decline in world trade halted, but the volume of trade actually began to rise. At first, depreciated-currency countries gained trade at the expense of countries maintaining relatively stable exchanges. Their greatest trade gains, however, were ultimately realized not with the gold standard countries, but with other depreciated-currency countries. Depreciation, to be sure, gave depreciated-currency countries certain price advantages in gold standard countries, advantages which did not develop in other depreciated-currency countries because of depreciation by those countries themselves. But the rise in production which accompanied depreciation in depreciated-currency countries originated an expansion in incomes in those countries which the stable-exchange countries did not ex-

<sup>81</sup> The figures for Germany are somewhat misleading. Nominally, she maintained stable exchange rates; in actual practice, however, much of her export trade was carried on in special marks which showed a depreciation of 35-40 per cent and more. Even this concealed depreciation does not tell the whole story, for after 1933 German foreign trade and the entire German economy became more and more subject to control by the government.

## 212 International Trade and Commercial Policy

perience (actually, incomes continued to decline in the latter), and increasing incomes may actually be more stimulating to world trade than price concessions.<sup>32</sup>

The gains in trade which depreciated-currency countries realized among themselves were thus due, in part, to the rise in incomes to which depreciation contributed, and, in part, to the fact that the countries which did depreciate were countries which normally have close trade relations with one another. New trade restrictions imposed by non-paper countries also interfered with the growth of trade between depreciated-paper-currency countries and non-paper countries.

In conclusion, there can be little question of the beneficial results of abandoning attempts to maintain stable exchanges during periods of severe deflation, like 1929–1932. A country may possibly solve its balance-of-payments problem by ruthlessly curbing imports and by subjecting the foreign exchanges to rigid government control. But to maintain exports through purgative doses of deflation produces such devastating effects on the internal economy that no government may expect to survive such treatment. Exchange depreciation offers a much quicker and less painful means of freeing a country from the ravages of deflation, and, at the same time, gives the authorities wide latitude to inaugurate recovery measures. But depreciation and devaluation are extreme measures, which should be resorted to only when the decline in prices and business recession are truly serious. For exchange depreciation and unstable exchanges themselves may have as disturbing effects upon world trade, and indirectly upon domestic trade and production, as stable exchange rates in a period of severe deflation. Depreciation which aims at *undervaluation* can have no justification whatever, for undervaluation in one country means overvaluation in others. Any departure from equilibrium rates is, therefore, as deflationary in some quarters as it is inflationary in others. Moreover, the special advantages which may come from undervaluation may be more than wiped out overnight by greater undervaluation by rival countries—currency depreciation is a game that more than one can play. Currency depreciation wars help nobody, and tend ultimately to injure everybody. It must also be remembered that the gains from currency

<sup>32</sup> See Harris, *op. cit.*, pp. xxiii, 477–478.

depreciation may be offset, in whole or in part, by the tariffs, quotas, and other restrictions to world trade which countries whose currencies are overvalued tend to impose in self-protection.

The new International Monetary Fund has been established for the purpose of forestalling any repetition of the competitive currency depreciation of the thirties. The Fund undertakes to promote exchange stability and to avoid competitive exchange depreciation, to provide the machinery for international consultation and collaboration, to fix the postwar structure of exchange rates, to assist in the removal of foreign exchange restrictions that hamper world trade, and to provide machinery for the maintenance of orderly exchange arrangements among member countries and for the orderly adjustment of exchange rates when necessary for the correction of fundamental disequilibria.<sup>33</sup>

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<sup>33</sup> The aims and functions of the International Monetary Fund are discussed in detail in Ch. XXVI, pp. 717-729.



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## *Tariffs: Their Nature and Effects*

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### THE RESTRICTIVE NATURE OF MODERN COMMERCIAL POLICY

Earlier chapters have shown that just as freedom of exchange between individuals maximizes the output of a single community, so freedom of exchange between nations maximizes world output. The geographical division of labor, like the division of labor among individuals, results in a larger world output of goods and services and a greater income for the constituent nations and regions than would flow from an organization of world resources in which geographical specialization was lacking. Anything which interferes with the international exchange of goods limits geographical specialization and consequently prevents the realization of this maximum income. Where the primary objective of a nation's commercial policy is, then, the maximization of its national income, the proper policy for that country to follow would appear to be one which will encourage untrammelled economic intercourse with foreign states.

Modern commercial policy is characterized almost universally, however, not so much by the encouragement which it offers to international exchange as by the obstacles it places in the way of such exchange.<sup>1</sup> Today, there is not a nation in the world that does not impede the full development of its commerce with foreign nations by the use of one, or several, of the ingenious devices of modern trade restriction: tariffs, prohibitions, quotas, foreign exchange control, clearing agreements, bounties, subsidies, buy-at-home cam-

<sup>1</sup> By "commercial policy" is meant all measures regulating the external economic relations of a country—measures adopted by a government to assist or hinder the export or import of goods and services.

## 216 International Trade and Commercial Policy

paigns, and various abuses of its customs administration. Great Britain, alone, from the middle of the nineteenth century down to the first World War, followed a policy of free trade; but the exigencies of war and reconstruction finally forced even that staunch defender of liberalism to abandon her long-tried policy of free trade for one of protection. While trade encouragement has not been lacking in commercial policy, as is evidenced by export bounties, government-supported, foreign market research organizations, consular establishments, preferential freight rates on exports, subsidized merchant marines, and the like, such encouragement has been deeply rooted in the philosophy of mercantilism, for only *exports* have been encouraged. Exports are not regarded as a means of paying for imports; imports are simply not wanted. The very nations which have done so much to encourage exports have at the same time adopted strong measures to curb imports. Both Germany and the United States, to mention only two among many, have expended large sums to develop foreign markets for their exports at the very time that they have both erected prohibitively high tariff walls against imports. But, as has already been shown, the restriction of imports tends to curb exports as well. The conclusion is therefore justified that commercial policy in modern times has been, in general, restrictive.

It will be the task of the present and the following three chapters to discuss the nature, objects, types, and effects of one of these tools of restriction, viz., tariffs; the discussion of other leading instruments of commercial policy will be postponed to later chapters.

### NATURE AND TYPES OF TARIFFS

A tariff may be defined simply as a duty, or tax, levied upon a commodity when it crosses a national boundary. More commonly, the term "tariff" is used to refer to a schedule of duties applicable to a list of commodities as the commodities are imported or exported. Tariffs, or customs duties as they are frequently called, are of three general classes: (1) transit duties, those levied on goods passing through one country and destined for another; (2) import duties, those levied on merchandise brought into the country; and (3) export duties, those levied on merchandise sent out of the country.

Customs duties may have as their object either the raising of revenue or the protection of home industry. But the distinction between the two is not always clear-cut. Many duties which are designed to be protective permit continued importation, although at a reduced rate, and, consequently, produce some revenue for the state treasury. Others which are designed solely to be revenue producers furnish some measure of protection. A country which produces no coffee, for instance, and places a low import duty upon imports of coffee with the sole intention of raising revenue may discover that the higher price for coffee, which results from the duty, diverts domestic demand to some extent from coffee to wine, or beer, or even milk, and thus inadvertently provides protection to these substitute industries.

A helpful means for distinguishing between revenue and protective duties is suggested by Professor Haberler, one that is purely objective and independent of the motives of either the legislators or the interested parties. Does the duty result in any discrimination between the domestic and the foreign supply? The duty is not protective if the goods produced at home bear the same taxation as similar imported goods, or if the goods subject to the duty are not produced at home even after the imposition of the tariff and if there are no substitute home-produced goods to which demand is diverted. A purely protective duty, on the other hand, forces a shifting of production away from the export industries toward the protected industry, or toward those substitute industries to which demand is diverted. A purely revenue duty will not cause a diversion of productive factors toward the production of the taxed goods or direct substitutes for the taxed goods; but it may cause some shifting of factors from the production of export goods to the production of those goods and services upon which the government expends its receipts.<sup>2</sup>

A nation which levies import duties not for protection but solely for revenue will ordinarily select for taxation a small number of commodities of wide consumption, and levy upon them rates low enough not to divert productive resources to the industries producing the goods taxed, or industries producing substitutes for those goods. Such was the character of the British tariff after that

<sup>2</sup> Haberler, *The Theory of International Trade*, pp. 238-239.

## 218 International Trade and Commercial Policy

nation adopted free trade in the middle of the nineteenth century. Duties were low, and were applied to only a few commodities consumed by the masses, e.g., sugar, tea, coffee, spirits, wine, and tobacco. The volume of imports was little affected by the very low duties, and the large consumption of the articles selected afforded a generous income to the British Treasury. Furthermore, the small number of goods taxed greatly simplified the task of collecting the duties. On the other hand, the country which is frankly committed to a policy of protection, like the United States, will find that the list of dutiable articles grows constantly longer, and the rates higher. In the first American tariff, that of 1789, rates ranged from 7½ to 15 per cent, with an estimated average of 8½ per cent. In the Hawley-Smoot Tariff of 1930, rates of 50 per cent and higher were common, and many articles enjoyed rates in excess of 100 per cent; the estimated average was 41 per cent.

There is, however, a distinct incompatibility between these two objects; of securing the greatest possible revenue for the state and affording the largest amount of protection to home industry. A duty which is completely protective excludes imports, and thus yields no revenue to the state. A duty on an article of general consumption, which causes imports to fall off but little, will yield a large revenue, but will afford virtually no protection to home industry. The extent to which a duty will cause imports to decline will depend upon the elasticity of the domestic demand for the dutiable goods and the degree to which the rise in price stimulates home production. Duties imposed upon commodities of wide consumption, which are not produced at home, will tend to be the best revenue producers. If it is desired to increase the state revenue by imposing import duties upon goods that are also produced at home, duties may be prevented from encouraging home production by levying upon the domestically-produced articles an excise tax equivalent to the import duty. Any given duty may, of course, be a compromise. Insofar as imports continue despite the duty, however, the government obtains revenue, but the protection is incomplete. Contrariwise, to the extent that the duty is effective in excluding foreign supplies and nurturing home industry, protection is attained but revenue is sacrificed. But, while the two ends of protection and revenue are

largely incompatible in the same duty, it is possible to attain both ends in an entire tariff schedule by selecting a few commodities of common consumption for very low duties and by granting prohibitively high rates to those others selected for protection.

### TRANSIT DUTIES

Transit duties—duties levied upon merchandise originating in one nation, passing through another, and consigned to a third—were a common instrument of commercial policy during the period of mercantilism, and were in force in several countries well into the nineteenth century. France did not abandon such duties until 1842, Germany until 1861, Austria until 1862, and Greece until 1884; and Russia levied duties upon goods in transit to Persia and Transcaucasia right down to the first World War. Today, transit duties are unimportant. The advent of the railroad has given rise to vigorous competition among various nations for the land carrying trade, and modern industrial nations have, as a result, found it advantageous to abolish such duties. Since 1850, furthermore, commercial treaties have usually contained a reciprocal provision which stipulates that merchandise passing between the nations party to the agreements should be free from all transit duties. In 1921, the Barcelona Statute on Freedom of Transit included an agreement for the abolition of all transit duties.

The probable effects of transit duties are an increase, in the importing country, in the prices of the goods upon which such duties are levied and a reduction in the volume of international trade.<sup>3</sup> Obviously, the entire economic life of a nation, a large part of whose export and import trade must pass through the territory of contiguous nations, could be profoundly altered by the imposition by these neighbors of transit duties upon its foreign commerce. The crippling effects of such duties upon German commerce of the first third of the nineteenth century are depicted by Friedrich List: "Thirty-eight customs boundaries in Germany cripple commerce . . . as if each limb of a man's body were bound so that blood could not flow over into another. To trade from Hamburg to Austria

<sup>3</sup> Conceivably, transit duties might be shifted to exporters. This possibility is discussed in the following section on import duties.

## 220 International Trade and Commercial Policy

or from Berlin to Switzerland you must go through ten states . . . pay ten transit duties."<sup>4</sup>

The power to levy prohibitive transit and import duties, which Prussia's strategic geographical position—controlling the trade routes of most of the other German states along the Rhine and Elbe rivers—gave her, was in considerable measure responsible for the development after 1818 of the German Zollverein, the customs union around which the modern German Empire was constructed. It is interesting to observe that the first German state to enter the Zollverein with Prussia, in 1819, was Schwarzburg-Sondershausen, a small state whose only access to the outside world was through Prussian territory, and all of whose foreign trade was at the mercy of Prussian transit duties.

### IMPORT DUTIES

Of the three classes of customs duties, import duties are by far the most universally used. Some nations levy duties on imports chiefly for revenue, others primarily for the protection of home industry, and still others for both revenue and protection. To legislators, import duties are an unusually attractive form of taxation because they possess the comforting feature of conferring benefits upon selected economic groups while at the same time concealing from those who ultimately pay the duties the size of the burden, or, for that matter, even the very existence of any tax burden. Since, however, they are generally paid by the consumer and, like general sales taxes, weigh more heavily on the poor than the wealthy, they violate one of the cardinal principles of taxation, namely, that a just tax is one adjusted to the ability to pay. In other words, import duties, unless levied solely upon luxuries, tend to be regressive.

Import duties have proved undependable as a source of revenue in the United States. Tariff revenue has been notoriously irregular, frequently out of balance with governmental expenditures, and practically impossible to control. In 1808 tariff revenue was nearly double total government expenditures, while in 1837 it was less than one-third expenditures, although at that time it was the government's chief source of income. It failed dismally to meet the war

<sup>4</sup> Quoted by Eugene Staley, *World Economy in Transition*, Council on Foreign Relations, New York, 1939, p. 53.

emergencies of 1812 and 1861. In the period between the Civil and the first World Wars, fluctuations in customs revenues were chiefly responsible for the succession of deficits and surpluses which testify to an imperfect financial system. One does not have to look far for an explanation. Since the tariff is regarded as an instrument to protect certain industries, its rates cannot be raised or lowered to meet changing fiscal needs without opening up the whole political conflict over protection. It is impossible, furthermore, to predict how changes in rates will affect revenues, because the whole relation between customs duties and customs revenues is complex and changing. An increase in rates may, for instance, lower total revenue by restricting imports, instead of increasing it as might be expected; while a reduction in rates may increase the yield by encouraging greater imports.

The importance of import duties as producers of revenue has declined in recent decades. Until the decade of the 1890's, customs receipts furnished at least one-half the ordinary receipts of the United States government. By 1914 these receipts had fallen to about 40 per cent of total receipts, by 1929 to 14.9 per cent, and for the fiscal year ending June 30, 1938, had shrunken to the relatively unimportant figure of 5.7 per cent—359 million dollars out of total government receipts of 6,242 millions. A similar trend is seen in other countries. In the years immediately preceding the first World War, import duties constituted less than 25 per cent of the total revenue of Great Britain, and about 15 per cent of the total revenue of France and Italy, respectively. One reason for this decline has been the growth of a keen international competition for world markets in manufactured goods, and this has made nations reluctant to impose import duties on raw materials and foodstuffs. But more important has been the spread of internal excise, income, and inheritance taxation. The prevailing ideas respecting the distribution of wealth and the greatly increased expenditures entailed by the interest, debt, and pension charges of two wars, the growing burden of relief and public works which the depression fostered, the rush to rearm, and the unprecedented burden of total war have so increased the demands for public revenues that import duties have proved to be woefully inadequate. Finally, the growth of autarchy since 1929 has emphasized the protective function of import duties



## 222 International Trade and Commercial Policy

at the expense of the revenue function, and it should be remembered that the two are to a large extent mutually exclusive.

### EFFECTS OF AN IMPORT DUTY UPON THE PRICE AND PRODUCTION OF A COMMODITY

It is a popular belief that an import duty operates to raise the price of the taxed good in the importing country by the full amount of the duty. Producers have schemed and lobbied for protective duties, convinced that they would reap the full benefit of new duties in an equivalent rise in the prices of their products, while opponents of protection have been only too eager to disseminate this belief in order to strengthen their attacks upon protection.

The incidence of imports duties is not nearly so simple. The truth is that the imposition of an import duty may affect the price of the good taxed in the importing country in several ways. The levying of the duty may have no effect at all on the domestic price; it may raise the domestic price by the exact amount of the duty; it may raise the price by less than the full amount of the duty; or it may raise the price to the consumer by more than the amount of the duty.

(1) An import duty on a commodity which is also exported by the country levying the duty has no effect upon the price of the commodity. The tariff of \$0.42 a bushel on wheat, which was granted the American farmer in the period of agricultural adversity after the first World War, utterly failed to raise the domestic price of this staple and thus improve the farmer's lot—and it was a foregone conclusion that it would fail. While American farmers raised annually an average of 800,000,000 bushels of wheat, American consumers consumed annually only about 600,000,000 bushels, thus leaving ordinarily something like 200,000,000 bushels to be sold in the export market. To understand how impossible it would be, under these conditions, to maintain a domestic price of \$1.02 a bushel for wheat at a time when the world price was \$0.60 a bushel, say, despite a tariff of \$0.42 a bushel, consider how American farmers would act in the face of such a price discrepancy—if it could exist. All domestic farmers would naturally undertake to sell their wheat in the home market at the higher price obtainable there. But, since the demand for wheat is relatively inelastic, and since normally the domestic production greatly exceeds domestic consumption, the

attempt to sell the entire American wheat crop, or nearly all of it, in the home market would force the domestic price down, even below the world price. Actually, however, the domestic price would not drop below the world price, because as soon as it began to drop to the level of the world price, sales of domestic wheat would be diverted from the domestic to the world market. With an exportable surplus, therefore, the American wheat farmer can expect to receive for his product no more than the world price, despite the generous \$0.42 a bushel tariff which a benevolent government has deigned to impose for his benefit. Only through some form of co-operative control which could succeed in restricting the amount sold on the domestic market to a quantity small enough to command a market price of \$1.02 could the tariff be made effective. This, in principle, was the objective of the Agricultural Adjustment Administration which was established by the Emergency Farm Relief Act of 1934.<sup>5</sup>

Another instance in which a tariff will not affect the domestic price of the taxed article is where the entire duty is borne by the foreign exporter. Such a situation is rare, but ardent protectionists, eager to forestall the complaints of consumers, sometimes imply that this is the usual effect of an import duty. An import duty might be borne by the foreign exporter if the duty-levying country were the dominant buyer and the good were produced by a foreign monopolist whose profits would be diminished less from the lowered price he would realize by absorbing the duty than from the smaller sales he would make if he maintained his former price. It might also be borne by the foreign exporter if the duty-levying country were, although not the dominant buyer, yet an important one, and if the monopolist-producer calculated that his profits would be better maintained by continuing his present output, charging the former price in his domestic and other foreign markets, but reducing the price by the amount of the duty in the duty-levying country.<sup>6</sup> Finally, the absorption of the duty by the foreign producer may be feasible for a brief period if the producer finds himself over-

<sup>5</sup> It is also true that the domestic price cannot be successfully pegged above the world price, allowing for transportation costs, without the aid of import restrictions.

<sup>6</sup> This implies a large and expensive plant. A fuller discussion of such policies, commonly known as "dumping," occurs in Ch. XXI.

## 224 International Trade and Commercial Policy

stocked. Rather than shut down his plant or cut prices universally, he may prefer to continue operations at a normal rate, maintain prices at home, and work off his surplus by cutting prices in export markets. Such a policy will, of course, be short lived, and will be abandoned as soon as the overstock is liquidated; then the export price will be raised to its former level—and the consumer will bear the duty.

(2) The domestic price will rise by the full amount of the duty if the commodity subject to the duty is produced at constant costs, i.e., if an indefinitely larger supply can be produced at the same unit costs as a smaller supply, and if, after the imposition of the duty, imports of the commodity continue. Since costs are constant, the entire supply of the good will be imported as long as the duty is less than the difference between foreign and domestic costs. The higher price resulting from the duty will naturally cause imports to decline.

If, under conditions of constant costs, the duty exactly equals the difference between foreign and domestic costs, the price in the duty-levying country will rise by the full amount of the duty. But in this case, since there is now no price advantage in buying the good abroad, the duty becomes protective and imports of the good cease.<sup>7</sup>

The cessation of imports and the fostering of home production,

<sup>7</sup> This is true of standardized goods. Where the commodity is not standardized, some imports may continue, if there are people to whom the foreign product is more desirable than the domestic. Consumers may have been served by two or more streams of heterogeneous supply, not by one stream of homogeneous supply. Professor Taussig cites, for example, the continuation of imports of pig iron into the United States during the last half of the nineteenth century after the imposition of a stiff duty. But almost all the imports were of *spiegel-eisen* and *ferro-manganese*, special qualities of the general product, used in comparatively small amounts for mixing with other iron in the Bessemer process. "This continued importation proved something about the relation between foreign and domestic prices for that particular grade, but nothing about the prices of the enormously greater quantity of pig-iron proper." F. W. Taussig, *Some Aspects of the Tariff Question* (1931 edition), Harvard University Press, p. 13.

Exceptional transportation conditions may, furthermore, permit the importation of a commodity into some part of a national market despite a duty, although the duty is prohibitory in respect to the general market. Steel rails have been carried by water from Europe around Cape Horn to Puget Sound and have paid a considerable duty, in spite of the fact that rails in the American steel centers were no dearer than in Europe. American rails would have had to pay the much higher charges of rail transportation. See *ibid.*, pp. 13-14.

however, involve a net loss to the community. As long as imports continue, even though they have to bear an import duty, there is no net national loss. For the increment in price resulting from the duty goes to the public treasury, and makes possible either a reduction in other taxes or an extension of governmental services. There is no such benefit offsetting the higher price resulting from the duty where importation ceases and domestic production of the good is substituted. Consumers pay a price augmented by the amount of the duty; but the public treasury receives no import duties on that portion of the supply which is produced at home. The amount by which the domestic price exceeds the foreign price represents merely an assessment against consumers to compensate for the inefficiency of domestic production.

(3) If the duty is greater than the difference between foreign and domestic costs, and if the good is produced under conditions of constant costs, imports will be entirely excluded; and if competitive conditions exist in the domestic industry, the price will rise only by the difference between foreign and domestic costs. This means that the price will rise by less than the amount of the duty. For, if the price rises by more than the difference between domestic and foreign costs, domestic producers will realize abnormal profits, and output will expand until price is brought down to the level of domestic costs. If the industry is dominated by a monopoly, however, or by only a few large producers, the price will in all likelihood be higher than under competition. It may, in rare instances, become so high that it exceeds the foreign price by the full amount of the duty.

Where the industry operates under increasing costs rather than constant costs, the effects of an import duty will be somewhat different. A duty levied on a commodity produced under conditions of increasing costs will cause the foreign price to deviate from the domestic price by an amount exactly equal to the duty, unless, of course, the duty is so high as to be prohibitive of imports. If the price difference were greater than the duty, imports would increase and the domestic price would fall; if the price difference were less than the duty, imports would be sold at a loss and would consequently decline in volume, thus permitting the domestic price to rise. But to say that the imposition of a duty will lead to a difference

## 226 International Trade and Commercial Policy

between foreign and domestic prices equal to the duty does not mean that the domestic price will rise by the full amount of the duty. The imposition of the duty will cause the price to rise in the importing country, and the higher price will reduce consumption, and perhaps even promote domestic production of the article. An expansion of domestic output can be attained, however, only at a higher marginal cost. The curtailment of output in the exporting country, which results from the smaller sales abroad, will, on the other hand, lead to lower marginal costs there. Thus, when a new equilibrium has been attained, the price of the commodity in the importing country will have risen by as much less than the duty as the price in the exporting country has fallen.

The nature of the adjustment may be clarified by the use of diagrams.

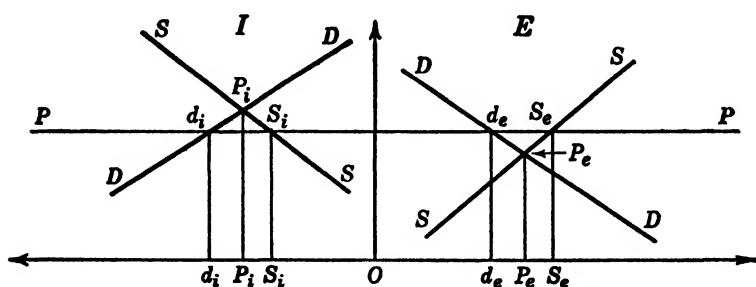


FIGURE 3.

In Figure 3 are shown the conditions of supply, demand, and price for a given commodity produced under conditions of increasing costs for countries I and E. The conditions in the importing country are shown in the left half of the diagram, with the horizontal scale reading from  $O$  toward the left. The right half of the diagram depicts conditions in the exporting country, with the horizontal scale reading in the familiar manner from  $O$  toward the right. In a state of isolation, both countries will produce the article; country I will produce quantity  $OP_i$ , selling at a price of  $P_iP_i$ , and country E will produce quantity  $OP_e$ , selling at the price  $P_eP_e$ . Upon the opening of trade, the article will be exported from E to I, and production will expand in E and contract in I. Equilibrium will be

reached at the price  $P$ , common to both countries. At this price production in I will have shrunk to  $OS_p$ , but consumption will have increased to  $Od_i$ . The difference between I's production and her consumption,  $d_iS_p$ , will represent I's imports from E. In country E, on the other hand, the higher price will cause output to expand from  $OP_e$  to  $OS_e$  and consumption to decline from  $OP_e$  to  $Od_e$ . The difference between production and consumption,  $d_eS_e$ , will be exported to I. Obviously, country E's exports,  $d_eS_e$ , must equal country I's imports,  $d_iS_i$ .<sup>8</sup>

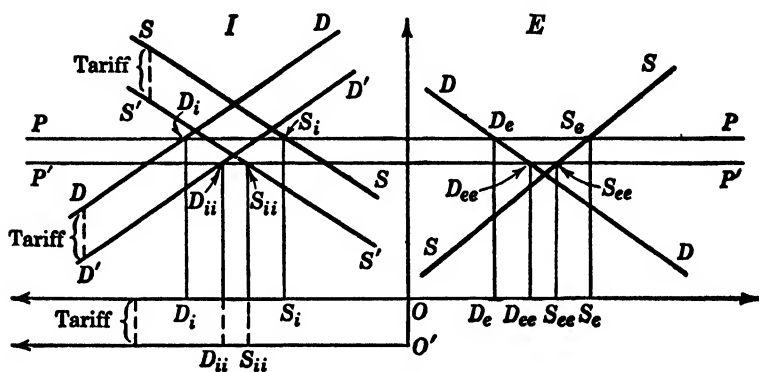


FIGURE 4.

What changes will take place if country I places an import duty on the article, a duty that is non-prohibitive, for a prohibitive duty would simply bring a reversion to the situation existing before the opening of trade? The amount of the tariff levied is assumed to be  $O'O$ . Since the imposition of an import duty by I is, to producers in E, the equivalent of a reduction in I's demand, or in the price obtainable from I consumers by the amount of the duty, it is necessary to lower the entire I section of the diagram by the amount of the duty (Figure 4). The vertical distance between the base lines  $O$  and  $O'$ , the demand curves  $DD$  and  $D'D'$ , and the supply curves  $SS$  and  $S'S'$  in I is in each case the equivalent of the duty.

A new equilibrium is established at the price  $P'P'$ , which in coun-

<sup>8</sup> The diagrams here used are similar to those employed by Gottfried von Haberler, *The Theory of International Trade*, pp. 171-172. By permission of The Macmillan Company, publishers. This discussion owes much to Professor Haberler.

## 228 International Trade and Commercial Policy

try E is lower than the previous price,  $PP$ . At this lower price, consumption in E will expand from  $OD_o$  to  $OD_{ec}$ , but E's production will shrink from  $OS_o$  to  $OS_{ec}$ . With a larger domestic consumption and a smaller output, E's exports must of necessity decline, from  $D_eS_o$  to  $D_{ec}S_{ec}$ . For country I, prices must now be measured from the base  $O'$ , instead of from the previous common base,  $O$ . It can be seen that the price in I rises by the amount of the duty minus the reduction in costs in E,  $PP'$ . The higher price for I curtails consumption, from  $D_i$  to  $D_{ii}$ , but stimulates production, the increase being from  $OS_i$  to  $OS_{ii}$ . With diminished consumption and greater domestic production, imports obviously will be less,  $D_{ii}S_{ii}$  instead of  $D_iS_i$ , but they will still exactly equal the smaller exports from E,  $D_{ec}S_{ec}$ .<sup>9</sup>

How much the price in the importing country will rise will depend chiefly upon the volume and elasticity of supply and demand in the importing and the exporting countries. The greater and the more elastic the demand in the importing country, i.e., the greater the extent to which purchases will decline with an increase in price, the smaller will be the price rise in the country of import and the greater the price fall in the country of export. A small decline in price will cause a sharp diminution in consumption in I; imports will fall off sharply and there will be little stimulation for added domestic production, with only a moderate increase in costs. The severe drop in export sales will cause a considerable shrinkage in production in the exporting country and a marked reduction in marginal costs.

If the demand in the exporting country is elastic and large, the fall in price there will be small, but the price rise in the importing country will be great. A small fall in price will attract a greatly enlarged domestic consumption to replace in large part the loss in exports. Exports will fall off much more than total output, and more than they would if demand were inelastic. A larger proportion of

<sup>9</sup> This method of analysis is applicable to only one commodity. In making use of it, one should keep in mind that it is assumed that other things remain unchanged. It should be noted, however, that the imposition of a duty causes changes in the balance of payments, sets in motion the monetary and foreign exchange mechanisms, and may even produce changes in the supply and demand curves for other goods.

the total demand of the importing country will have to be met from domestic production, at mounting costs.

The greater and the more elastic her supply, the smaller will be the decline in price in the exporting country, and, conversely, the greater will be the rise in price in the importing country. With an elastic supply, production in the exporting country will fall off sharply as the price falls. But the sharp reduction in her imports will mean that more of the importing country's supply must be produced at home, at higher and rising costs, i.e., higher than if output in the exporting country were restricted but little. Therefore, the exporting country will be protected from a drastic price decline if her supply is elastic. It is probably true that supply is more elastic in the long run than in the short run. For once plant is erected, it is generally more profitable to utilize it at optimum capacity than to abandon it, even though price falls to a point which yields less than the anticipated return, provided, of course, variable costs are covered. When it is necessary to replace the plant, however, replacement will not be made unless the price of the product is high enough to afford the current yield on comparable investments; therefore, production will cease.

If supply in the importing country is elastic, on the other hand, the increase in price there will be relatively small, but the fall in price in the exporting country will be correspondingly large. An elastic supply for the country of importation means that an increased domestic output will encounter only slowly rising costs. But this ready supplantation in their export market by protected competitors will force producers in the exporting country to curtail their production greatly, and their marginal costs will fall.<sup>10</sup>

(4) Finally, the consumer frequently pays a price enhanced by *more* than the amount of the duty, for ordinarily the imported article is not imported directly by the ultimate consumer but must pass through the hands of one or more middlemen. The increase in the price paid by the consumer exceeds the amount of the duty because the middleman customarily marks up his cost price by a fixed

<sup>10</sup> For this material on the degree of the price changes caused by import duties, I am indebted to Professor Haberler, *op. cit.*, pp. 227-232. See also Ellsworth, *International Economics*, pp. 294-295.



## 230 International Trade and Commercial Policy

percentage, and this percentage markup applies to the duty as well as to the price paid by the middleman. An illustration may help clarify this pyramiding of the duty.

Consider the case of imported shoes for which the importer pays \$3.00 a pair, laid down at the port of entry. Assume that the importer sells directly to the retailer, so that the shoes pass through the hands of only two middlemen. The import price, duty, markups, and retail price are shown in the accompanying tabulation. If we

	No Tariff	50% Ad Valorem Tariff
Importer's c.i.f. price	\$3.00	\$3.00
Duty paid to the government	0.00	1.50
Total cost to importer	3.00	4.50
Importer's markup 33 $\frac{1}{3}$ %	1.00	1.50
Total cost to retailer	4.00	6.00
Retailer's markup	1.33	2.00
Price to consumer	5.33	8.00

assume a markup of 33 $\frac{1}{3}$  per cent by both the importer and the retailer, the consumer will pay a price of \$5.33 when there is no tariff, as indicated in the first column of the table.<sup>11</sup> Of the \$5.33 paid by the consumer, \$3.00 represents the imported price and \$2.33 the middlemen's profits.

If, now, a tariff equivalent to 50 per cent of the value of the shoes is levied, the price to the consumer rises to \$8.00 (second column of the table). Of the \$8.00 which the consumer pays, \$3.00 goes to the foreign producer and the transportation agencies, as in the former case, \$1.50 is paid to the government, and \$3.50 is retained by the middlemen. The imposition of a duty of \$1.50 thus forces the consumer to pay a price \$2.67 higher than when no duty was collected. The difference between the duty and the price increment, or \$1.17,

<sup>11</sup> The percentage of markup will vary in different trades. For some it will be less than 33 $\frac{1}{3}$  per cent, for others it will exceed that figure. A markup of 33 $\frac{1}{3}$  per cent is probably not uncommon. The ratio of markup will, however, affect only the size of the result, not the result itself.

goes to the middlemen. Obviously, the use of import duties for raising revenue does violence to Adam Smith's fourth canon of taxation, namely, that "every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state."<sup>12</sup>

The principles enunciated in subsections (2) and (3) of this section, which deal with situations in which the imposition of an import duty will cause the price of the good to rise in the importing country either by the full amount of the duty or by less than the duty, should, of course, be modified to allow for this pyramiding of the duty in middlemen's markups. When the duty is a raw material of industry, a similar pyramiding of the duty through the manufacturing and merchandising processes takes place. Only when the good is imported directly by the ultimate consumer is it avoided.

We have examined in this section the direct effects of an import duty upon the price and production of the taxed commodity. But the imposition of an import duty has ulterior consequences: it affects indirectly the demands for the factors of production and the demands for other commodities, and in turn their supplies and prices. These possible changes are too intricate and too multitu-

<sup>12</sup> Some economists deny that a tax levied on importers, or producers, can be pyramided in the long run. It is argued that the pyramiding of the tax will swell the profits of middlemen and that these higher profits will in turn stimulate competition, until the price is finally forced down to a point where it is higher than the former price by only the amount of the tax. See D. Philip Locklin, *Economics of Transportation*, rev. ed., 1938, p. 98.

There are reasons for doubting, however, that competition will hold the retail (and wholesale) price of an imported commodity down to a level no higher than the price prior to the imposition of an import duty plus the duty. First, the imposition of the duty will cause some rise in the retail (and wholesale) price of the taxed article, and, unless the demand for the article is perfectly inelastic, a most infrequent situation, dealers' sales will decline. With smaller sales, dealers' total profits may be no greater than previously, and may actually be smaller, despite the greater dollars-and-cents markup per unit. Second, the taxed article may contribute such a small percentage to dealers' total sales that even if the total profits on the taxed commodity do increase as a result of pyramiding the duty, their total profits will be enhanced by an amount so small that they offer little additional inducement for newcomers to enter the trade. Finally, in case retail sales do perchance hold at a level so high that the customary percentage markup swells the profits of dealers, the argument assumes a keener degree of price competition in retail trade than actually exists.

## 232 International Trade and Commercial Policy

dinous to trace at length here, but their general nature may be briefly indicated.

Imports of any commodity will decline when that commodity is subjected to an import duty. And, unless the elasticity of the domestic demand for the article is unitary, the amount spent on imports of the article will undergo alteration. This change in the volume of foreign payments will not only create disequilibrium in the balance of international payments and thus set in motion the monetary and foreign exchange mechanisms, with consequent alterations in price structures; it will, in addition, cause changes in spending, both for domestic goods and for imports. Shifts in the direction of spending will, moreover, bring about changes in factor prices and in the prices and outputs of goods. For example, if the domestic demand for the good now taxed is elastic, the total amount spent for this good will decline, and eventually a corresponding decline in exports may be expected. The demand for domestic goods will increase, since purchasing power formerly directed to buying imports is now released. The demand for productive factors used chiefly in the export industries will decline while that for factors used largely in domestic industries will increase, with corresponding changes in their prices. These changes in factor prices will necessitate changes in commodity prices and in the outputs of different commodities. Changes in some respects similar, and in some different, will be induced if the demand for the dutiable good is inelastic. The alterations in commodity and factor prices will also be influenced by the ways in which the state spends the revenue derived from the duty.

### EXPORT DUTIES

Export duties, although relatively little used by industrial nations after the middle of the nineteenth century, were earlier very common. In ancient Greece, ancient Rome, and practically all countries of Europe during the Middle Ages, export taxes were an outstanding source of government revenue. They were first imposed by statute in England in 1275, and applied to wool and hides. Their use in Europe rapidly increased from the thirteenth to the middle of the seventeenth century; some idea of their popularity can be gleaned from the fact that by 1660 England was subjecting 212 articles to such duties. The popularity of these duties during this period is to

be explained largely by the then current belief that the foreigner paid the tax. The later realization that they tended to restrict exports and the rise of free trade policies in the nineteenth century made them less popular, and they were abolished in England in 1842, in France in 1857, and in Prussia in 1865. Nevertheless, at the outbreak of the first World War many isolated instances of export duties were to be found. Italy levied such duties on art objects, silk waste, and lead and copper ores; Spain levied export duties on cork, iron, and textile waste; Russia taxed a long list of exports of agricultural and mineral products; and Rumania taxed exports of forest products, rags, and hides. In the United States, the levying of export duties is prohibited by the Constitution (Article I, Section 9); this prohibition resulted chiefly from the insistence of Southern agricultural interests, who thereby sought to avoid any interference with the export of their agricultural products. A similar prohibition has been placed by federal statute on Alaska, Hawaii, and Puerto Rico. A few of these duties exist, however, in the Virgin Islands.

The need for revenue and the growth of nationalistic commercial policies, which have characterized the years since the Treaty of Versailles, and particularly those following the onset of the depression of the 1930's, have resuscitated the popularity of export duties. France levied export duties on butter, cheese, poultry, and art objects; Czechoslovakia on glass, timber, fresh fruit, kaolin, and hops; Finland on lumber, paper, and pulp; while many other nations of Europe collected duties on exports of numbers of their national products.

Export duties, like import duties, may be levied for revenue or for protection. Export duties are much more common in countries which produce chiefly raw materials and foodstuffs than in the more highly industrialized countries, and in the former are primarily for revenue. In these economically backward countries, with their relatively sparse populations living largely in rural areas, export taxes are easy to collect as compared to income taxes. Taxes are collected at only a few points, the ports of exportation, and upon the mere act of exporting; and no elaborate system of accounts nor large staff of administrative officers is required for their collection.

Some countries rely upon these customs receipts for a large proportion of their total revenue. In Central and South America they

## 234 International Trade and Commercial Policy

are imposed on almost all exports. Duties ordinarily range from one to five per cent, but in some instances exceed 10 per cent. Countries making such general application of export taxes include Argentina, the majority of the Brazilian states, Uruguay, Peru, Salvador, Haiti, Egypt, Syria, Iraq, Arabia, the Belgian Congo, Portugal, and Albania. The potential productivity of export duties is revealed by the experience of Chile: until a short while ago that nation obtained 80 per cent of her total government revenue from this source. In India and China, such duties have frequently yielded more than import duties. While an export duty whose sole purpose is revenue production may be assessed against all exports, as a rule the duty is assessed against only the most important ones, as in the cases of the export duties on raw jute and rice in India, on diamonds in the Union of South Africa, and on sodium nitrate in Chile, which for many years provided half the total of Chile's revenue.

When the primary purpose of the duty is to produce revenue, the duty will not, as a rule, be high. Turkey and the Sudan for a long time collected on all goods exported a duty equal to one per cent of their value; the Dutch, Italian, and Portuguese colonies as well as the Belgian Congo have recently collected a two per cent tax on all exports. High export duties became politically unfeasible as the belief became more widely accepted that the duty is definitively borne by the domestic producers. Since the producer can charge the foreign buyer no more than the world price, it is reasoned, the receipts of the producer will equal the world price minus the duty and transportation charges.

The equity of the export tax has been questioned. Unlike the profits tax, the export tax ignores differences in the net earnings of concerns and thus penalizes the high-cost producer, whose net earnings are much smaller, relative to his exports, than the low-cost producer's. In some colonies, where large plantation owners and native producers are both producing for export, an attempt has been made to remedy this inequity, in part at least, by levying profits taxes against the large estate owners and by collecting export taxes on only the products of the natives.

Export duties are sometimes levied for purposes of protection, but these protective export duties are not as numerous as those designed chiefly to yield revenue. Protective duties are sometimes assessed

upon exports of raw materials, with the intent of making the price of the raw materials to foreign industries higher than to domestic industries and thus of encouraging the development of domestic manufactures. Spain and Portugal, for example, have levied duties on exports of raw cork, in part for revenue but also to encourage the domestic cork-manufacturing industry. British India imposed a duty of 15 per cent on exports of untanned hides and skins between 1919 and 1923 in order to protect the young Indian tanning industry which had taken root during the first World War. Before the War, Germany had controlled the trade in these products to a large extent, and the raw materials were sent there to be tanned. Export duties on rags were a common feature of European tariffs before wood came to be so largely used as the chief raw material in paper-making. And more recently, duties on exports of wood and timber from Norway and Sweden have had as one of their chief objectives the encouragement of the woodworking and pulp industries in those countries.<sup>13</sup>

Duties have also been assessed against exports from colonies for the purpose of protecting not the colonial industries but industries in the mother country. When used for this purpose, export duties

<sup>13</sup> Export prohibitions resemble export duties in their effects. Although export prohibitions were numerous during the mercantilist period, they play an insignificant role in modern trade policy, except in wartime when they may be applied to insure sufficient supplies of essential raw materials and foodstuffs for civil and military needs. Where they are used today, they generally apply to raw materials and are intended to encourage the development of domestic manufactures for the working-up of these materials. Rumania, for instance, prohibits the export of crude oil in order to protect her own refineries. Canada, in order to encourage the domestic manufacture of pulp and paper, has placed an embargo on exports of pulpwood from Crown lands, which produce 92 per cent of the pulpwood output of the Dominion. The Province of Ontario went further than the other provinces and required the pulp to be manufactured into paper before it could be exported. As a result of these embargoes, less than one-fifth of the pulpwood cut in 1930 was exported, compared with more than two-thirds in 1900.

Absurd situations may develop from the simultaneous use of import and export restrictions by two countries. One such situation is described by Haberler. Rumania protects her oil refineries by an embargo on exports of crude oil, while Austria, a natural market for Rumanian oil, protects her refineries by restricting the importation of refined oil. The dilemma has been resolved by Rumania refining the oil, then remixing the refined joint products and exporting the refined mixture to Austria, where the mixture is refined again! See Haberler, *op cit.*, p. 347.

## 236 International Trade and Commercial Policy

become preferential, i.e., exports of goods from the colony to the mother country pay no duty, or a low duty, while exports to all other countries pay a duty, or pay at a higher rate. Prior to 1903, export duties were levied upon tin and tin ore by the Federated Malay States as a part of their fiscal system. There was no discrimination. In 1903, an additional duty of 30 Straits dollars per picul was imposed on all tin ore exported without a guarantee that it would be smelted in the British Colony of the Straits Settlements. This exemption from the additional duty under a like guarantee was extended in 1904 to Great Britain, and in 1916 to Australia. The object of this preferential duty appears to have been the protection of tin smelters in the British Empire against a smelting works which was being erected in New Jersey at the time. The success of the measure was promoted by the fact that the most important sources of tin ore in the world were the tin mines in the Federated Malay States. As a result of this preferential export duty, the tin-smelting industry in the United States was effectively stifled.

The British Empire has made use of discriminatory export duties in still other instances. From 1919 to 1923, two-thirds of the duty on hides and skins exported from India was remitted if bonds were given that the hides and skins would be tanned within the British Empire. A double duty was levied on palm kernels, an important raw material in the vegetable oil-crushing industry, exported from British West Africa from 1919 to 1922 to points outside the British Empire, or in cases where a guarantee was lacking that crushing would take place within the Empire. The United States has not been guiltless of this discriminatory practice. From 1902 to 1913, exports of manila hemp from the Philippines direct to the United States for American consumption were exempted from the duty of \$0.75 per 100 kilos, which hemp exports to other countries had to bear.

Preferential export duties on materials of which the colony has a virtual monopoly constitute fertile soil for the seeds of international ill will. Consumers outside the Empire bitterly resent being gouged by the tax collector of the Empire. When the preference is prohibitive, foreign nations are even deprived of industries which they may consider essential for their national defense. The German break through the French and British armies in May, 1940, made the American people suddenly realize the extent to which the preferen-

tial Malayan export duty on tin ore had made them dependent on the British Empire for supplies of this vital mineral. The desire for control over sources of vital raw materials was one of the leading excuses advanced by the dictator nations for their aggressions in the 1930's and early 1940's. A more complete discussion of tariff preferences must, however, be postponed to the chapters on colonies and raw materials.

Export duties have been levied in some instances to prevent a valuable and nonreplenishable natural resource from being exhausted, or from being used up at too rapid a rate. Great Britain in 1901 levied an export duty of one shilling a ton on coal whenever the price per ton exceeded six shillings, in part to increase the state's revenue but mainly to protect her coal supply. The duty was abandoned in 1906 in the face of rapidly increasing competition from German coal.

The Philippines, before the invasion by the Japanese, levied a tax upon the exportation of cigars, and spent the proceeds on advertising Philippine cigars in the United States. Still another interesting use of export duties was the German adoption of such duties during the period of disturbed currencies and foreign exchanges following the first World War, in order to prevent the sale abroad of finished products for a smaller sum (expressed in foreign currencies) than the imported raw materials had cost. This anomalous price situation arose from the fact that the prices of foreign currencies were rising much faster in the foreign exchange market than were commodity prices within Germany. Governments have also collected taxes on exports to defray the costs of promoting sales abroad by research and by governmental control over quality.

#### EFFECTS OF EXPORT DUTIES ON PRICES AND OUTPUT

How will the imposition of an export duty on a given commodity affect production of the commodity and the price received by producers in the duty-levying country, and the price which consumers must pay in the world market? The commonly accepted view is that the burden of such a tax is borne by the producer. Since he must meet the world price, it is reasoned, he will receive the world price minus export duty and transportation charges. The higher the export duty and the freight charges, the smaller will be the net amount



## 238 International Trade and Commercial Policy

which is left to him.<sup>14</sup> If the commodity is produced under conditions of competition, and if the nation levying the duty furnishes but a small proportion of world exports, it is true that the price to the producers in the country imposing the duty will fall by approximately the amount of the duty, and there will probably be a relatively large drop in that country's output.

If the duty-levying nation furnishes an important fraction of world exports, however, and if the domestic supply is elastic, any fall in the price to domestic producers will bring a sharp fall in that country's output and will cause some rise in the world price. The more inelastic the supply, the less will be the rise in the world price and the greater will be the fall in the price received by domestic producers. Supply is probably more elastic for mineral products than for agricultural products, because the number of producers is often greater in agriculture and concerted control over supply is therefore more difficult.

The elasticity of the world demand will also affect the incidence of the export duty. When the world demand is elastic, the world price to consumers will rise less and the price to producers and output in the duty-levying country will fall more than when the world demand is inelastic. Where the commodity taxed is a foodstuff or raw material, the more common objects of export duties, domestic demand will probably be inelastic, and in the case of raw materials unimportant. Domestic demand will consequently be of little aid in preventing a fall in price to domestic producers where the world demand is elastic.

Where a nation has a monopoly, or near monopoly, of a product, the imposition of an export duty will result in a greater rise in the price to world consumers and a smaller fall in the price to producers than when there are competing sources. The maintenance of price for producers will be accomplished by a sharper curtailment of output than is likely where alternative supplies are accessible. But the tendency to force the payment of the tax upon the shoulders of consumers will be tempered by other factors. Where the world demand is elastic, the monopolist will prefer to avoid too great a reduction in output by accepting a part of the tax burden in the form of a lower price. And likewise, if he has heavy overhead costs, he may find it

<sup>14</sup> See J. Anton de Haas, *Practice of Foreign Trade*, p. 65.

preferable to keep unit costs down by maintaining output, even though this means a lower selling price. But a nation which has a monopoly of the production of some raw material or foodstuff will probably have many production units, so that the abandonment of marginal mines, farms, or plantations will be feasible and the reduction of output more attractive than when only one production unit is involved.

The most important restraints on the monopoly power of a nation which may seek to shift the burden of an export tax to the shoulders of foreign consumers are, however, the ever-present possibilities of the development of alternative sources of supply, somewhat, but not too greatly, inferior to its own, and substitution. Prior to 1860, Bengal had somewhat of a monopoly of saltpetre. In that year the export duty of saltpetre was raised from 3 to 20 per cent ad valorem. Exports declined immediately, and when the duty was finally removed in 1867, exports were scarcely one-third those of 1860. Another example of a monopoly control which was intended to mulct the foreign consumer but which backfired is that of Chilean nitrates. The rich reserves of sodium nitrate within the confines of Chile have given her a virtual monopoly of the supply of natural nitrates. In 1919, a control over exports of the material was instituted, which included among other things an export tax. The result of the high world price which ensued was to encourage the manufacture of synthetic nitrogen, obtained through the fixation of nitrogen from the air, so that by 1927, despite a marked expansion in the world consumption of nitrates, the proportion of natural nitrates to the total world consumption had declined to 21 per cent, compared with 55 per cent in 1913.

The cheapening of transportation afforded by the railroad and the steamship has reduced cost differentials between different sources of supply and destroyed the monopoly position of many raw-material producing countries. Furthermore, the ease with which capital flows from nations with a surplus to underdeveloped regions facilitates the bringing into life of new enterprises and the transforming of potential competition into actual competition. Any nation that contemplates the employment of export duties must face the ever-present threat that the adoption of any but low duties is apt to forestall the anticipated increase in revenue by stimulating the de-

## 240 International Trade and Commercial Policy

velopment of competing sources of supply at the expense of its own producers.

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## *The Content and Form of Tariff Laws. Bounties*

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### TARIFFS

The decision to adopt a tariff system, whether as a means of obtaining revenue for the state or as an instrument for the protection of home industries, immediately raises many other problems, problems of a somewhat technical nature. These problems concern the territorial scope of the tariff law, the kinds of duties to be employed, the form of the tariff schedule, i.e., whether it is to be single or multiple, the extent to which the tariff schedule set by the legislature shall later be modified by international treaties, the extent to which classification shall be carried, and the basis upon which imported goods shall be valued for tax purposes, to say nothing of the broader questions of what goods shall be dutiable and how high the duties shall be.

An understanding of these technical matters is important, not only for the legislators and the administrators to whom is entrusted the practical application of the general tariff policy, but for importers, domestic producers, domestic consumers, and students of commercial policy as well. The choice of the particular kind of duty may affect the success with which the basic tariff policy is carried out; the form of the tariff schedule may deeply affect the country's success in tariff bargaining and influence its future trade relations with other countries, and, thus, domestic production; while failure to give sufficient attention to the classification and valuation provisions of the tariff law may result in serious modification, or even evasion, of the real intent of the legislators. These technical aspects of tariffs are discussed in the present chapter.

## 242 International Trade and Commercial Policy

### CUSTOMS AREAS

Since customs duties are taxes levied upon goods entering (or leaving) the customs area, the demarcation of the customs area is of considerable importance in the administration of the tariff law; it has in some instances been a means of actual discrimination. The tariff area is usually made coextensive and conterminous with the national political area, so that tariff and political sovereignty and administration coincide. But colonies are generally excluded from the tariff area. Thus, the tariff law of Great Britain is applicable to Great Britain (England, Scotland, and Wales) and Northern Ireland, but not to the English colonies, which have special tariff laws of their own. The little Isle of Man, also, has a separate tariff act. Some nations, however, have assimilated their colonies into their own tariff area. The French tariff, for example, extends to many of the French colonies, but not to all, while that of the United States applies not only to the continental United States but to all the territory under its sovereignty, with the minor exceptions of the Virgin Islands, Guam, American Samoa, and the Panama Canal Zone. Tariff assimilation makes for simplicity in tariff administration. When the tariff is framed primarily in the interests of the mother country, however, it may not afford ample protection to colonial producers, nor yield sufficient revenue to the colonial treasury.

But there are exceptions to the general principle that the tariff area coincides with the national political area. In some instances the tariff law does not apply to all the territory of a state, while in others it includes foreign territory. The German customs union did not include the free cities of Hamburg and Bremen until 1888, and the two Adriatic cities of Trieste and Fiume were not brought into the Austro-Hungarian customs union until 1891. It sometimes happens that a part of one country belongs to the customs area of another. Two Austrian villages, Mittleberg and Jungholz, were economically so dependent on Germany that they were eventually incorporated into the German customs union. This was also true of Luxembourg, prior to the first World War. The French hinterland of Geneva was a part of the Swiss customs system until 1918.

Countries with long land frontiers sometimes establish a frontier area, from four to ten kilometers in width, which lies outside the

## **The Content and Form of Tariff Laws. Bounties 243**

tariff area of either country and within which local trade is free of duty. Such an area is marked off for the convenience of those inhabitants of the two countries who live close to the border and whose economic dealings with persons within the area are more important than their transactions with persons outside. Trade between such areas and the remaining territory of the two countries within the tariff boundaries is dutiable.

Two or more countries may be united for purposes of customs administration by customs union or customs annexation. After the first World War Belgium and Luxembourg united for customs purposes. The classic example of such a union is the German Zollverein, which in 1834 welded into a single customs administration the separate German states, until the formation of the Empire in 1871; the Zollverein thus brought about economic unity decades before political unity was realized. By the Convention of Paris of November, 1920, Poland and the free city of Danzig constituted a customs union.

Another form of customs unification is customs annexation, by which one country becomes included in the customs territory of another. In a customs union, every participating country has a certain participation in the affairs of the customs union; under customs annexation, one of the contracting countries does not interfere in customs matters. Examples of customs annexation are the inclusion of the Principality of Monaco with France in 1865, and the inclusion of the Principality of Liechtenstein with Austria from 1852 to 1919, and with Switzerland from 1923 on.

### **THE FORMS OF TARIFF SYSTEMS**

The tariff schedule is the list of all existing import duties. Tariff systems may be classified according to two different bases: (1) the number of schedules constituting the tariff, and (2) whether the schedules of duties are established by law or by treaty with another nation, or nations. According to the first classification, the tariff may be single-schedule, containing only one schedule of duties, or multiple-schedule, containing two or more separate schedules. Schedules of duties established by law are known as autonomous, or statutory, tariffs, while those established by treaty are known as conventional tariffs. Single-schedule tariffs are almost always autonomous, while

## 244 International Trade and Commercial Policy

multiple-schedule tariffs may be either entirely autonomous or partially conventional. There are many variants of the multiple system, but its most frequent forms are the general-and-conventional, the maximum-and-minimum, and the preferential. The preferential system frequently has three schedules.

*The Single-Schedule Tariff.* The single-schedule, or single-line, tariff is the simplest form, and is, with few exceptions, created solely by an act of the legislative branch of the government. An autonomous country can, however, conventionalize its tariff, if it chooses to bind itself by treaty to a particular level of duties. In the single-line tariff there is but one rate of duty for each article of import, regardless of the particular country of origin. Because it is non-discriminatory, it is relatively easy to construct and to administer; under such a tariff, the executive branch of the government has little responsibility beyond the actual assessment and collection of duties. Administration may be complicated, however, if duties are levied on an ad valorem basis and if a particular article is imported from several different countries, in each of which the price of the article is different. In such a case, the duty collected will vary with the country of origin, although the rate of duty is the same in each case. The single-line tariff is most commonly used (1) for protection, where the nation has no intention of bargaining, or (2) where the sole purpose of the tariff is revenue. It has been used by Denmark, Great Britain before 1914, the Netherlands, China under the "Open Door" policy of the great powers (a non-autonomous tariff), and the United States under many of her tariff acts, including those of 1922 and 1930.

Many nations have abandoned the single-schedule tariff because they feel that it handicaps them in developing their foreign commerce: it is believed that the system precludes their obtaining reductions in the duties of other countries in return for reciprocal reductions on their own part. Other countries may be unwilling to grant concessions, for, if they do so, they will be no better off than their competitors who have made no such reductions. Situations could arise, however, in which the prospects of a restricted, or an expanded, market, which the threat of a rise in duties, or the promise of a reduction in duties, by a single-line tariff country holds for another country, would induce the latter to lower its duties on im-

ports from the former. This might occur where the single-schedule tariff country was the chief market for one of the country's leading exports, and where the latter was the chief supplier of the article.

*The General-and-Conventional Form.* Because of the handicaps which the single-schedule tariff imposes upon the expansion of foreign trade through tariff bargaining, double-schedule forms have been developed. Under the general-and-conventional system, the legislature fixes only one schedule of duties. These constitute the general tariff, and are applicable to imports from all countries with which this country has no treaty or agreement. But conventions may be made with foreign countries, which grant these countries reductions from the general tariff on certain articles, usually for equivalent concessions. These reduced duties may be extended automatically, under most-favored-nation treaties, to all nations entitled to most-favored-nation treatment. The total of all these reduced rates makes up the conventional tariff. The conventional tariff, it should be noted, is established by treaty, not by statute. And it is a composite schedule resulting generally from several treaties, for each nation bargains for reductions only on those articles in which it is interested. On articles on which no foreign nation has been successful in bargaining for reduced rates, there will be only one duty—the statutory, or general, rate.

The general tariff may be put into operation before the conclusion of commercial conventions; or its operation may be delayed until the principal commercial conventions have been concluded, so that the general and the conventional schedules are put into force at the same time. The duties of the conventional tariff are consolidated, i.e., they cannot be modified while the agreement by which they were established is in force. While duties in the general tariff are generally autonomous and, as such, may be altered, particular duties of the general tariff may be consolidated, if negotiating nations have been unsuccessful in obtaining conventional rates on these articles.

The general-and-conventional tariff was a popular form of tariff construction among European nations between 1860 and 1914. Its prototype was the Cobden-Chevalier Treaty, which was concluded in the former year between France and England and established mutually lower duties. Napoleon III of France found it easier to



## 246 International Trade and Commercial Policy

bring about the reduction in French duties which he desired by treaty negotiation, which was then part of the imperial power, than by direct legislation by an unwilling legislature. The Cobden treaty with England was followed by similar treaties with several other states, and the conventional tariff became the basic tariff in France until the change in French tariff policy in 1892. Germany inaugurated a similar system, which was in effect down to 1914, and her example was followed by so many nations throughout Europe that the general-and-conventional tariff became the dominant type on the Continent. After the first World War the system was adopted, or continued, by Italy, Belgium, Switzerland, Sweden, and others.

*The Maximum-and-Minimum Form.* The maximum-and-minimum tariff, like the general-and-conventional tariff, has two schedules of duties, a lower one applicable to the products of those countries which have obtained it by convention and which enjoy most-favored-nation treatment, and a higher one for all other countries. It differs from the general-and-conventional tariff in two respects. First, it has two rates on *every* article on which duties are levied, not just on those goods on which conventional rates have been established; and second, the rates in both schedules are fixed, as a rule, by domestic legislation, not by agreement with foreign countries, as are the conventional rates of the general-and-conventional tariff. The maximum-and-minimum tariff is thus an autonomous tariff in both schedules, and can be modified by the legislature at any time to meet the needs of the country. Duties may not be reduced or consolidated by executive action in either the maximum or the minimum schedules. The minimum schedule represents what is regarded as the lowest possible rates consistent with providing protection, or yielding the necessary revenue, at the time of the passage of the tariff law.

By some countries, e.g., France, the minimum tariff is considered specially favorable treatment, and the maximum tariff is consequently considered normal treatment. Other countries, such as Belgium, reverse this procedure and treat the minimum duties as normal, reserving the maximum duties as a threat in bargaining or as a penalty against discrimination by foreign countries. The United States tried a brief experiment with such a system by incorporating in the Tariff Act of 1909 a provision for imposing, in addition to the

rates of the regular tariff schedule, a duty of 25 per cent ad valorem on goods coming from countries which were unduly discriminatory against American products. The minimum rates, in other words, were those of the regular tariff, while the maximum rates were minimum rates plus a sum equal to 25 per cent of the value of the goods. Maximum rates, which were penal rates, were never actually applied against any country, and the whole maximum-and-minimum feature of our tariff was swept away by the Tariff Act of 1913.

While the maximum-and-minimum tariff is autonomous in principle, duties have in practice been reduced or consolidated, on occasion, by agreements with foreign countries. Spain, the country first to adopt such a tariff (in 1877), later modified the policy of customs autonomy by commercial conventions; and in 1927 France modified her policy of customs autonomy in an agreement with Germany, by which the latter obtained reductions and consolidations of many duties.

*Merits and Defects of the Two Forms of Double-Line Tariffs.* The general-and-conventional and the maximum-and-minimum tariffs are both bargaining tariffs, and, as such, make discrimination possible. Both are complex and difficult to construct and administer. Where some imports of a commodity come in at one rate and some at a different rate, it is always difficult, if not impossible, to predict with any degree of accuracy the amount of protection likely to be afforded to home producers or the total revenue likely to be raised.

Under the maximum-and-minimum tariff, the two schedules of rates are fixed and known, and home producers know that for the duration of the tariff act they can count upon the protection afforded by the minimum duties. At the same time, since the tariff is autonomous, the legislature may alter the duties at any time, if it seems desirable, without awaiting the consent of any other nation or the expiration of a treaty. Bargaining power is limited, however, since the largest concession that can be offered is the difference between the maximum and the minimum rates, a reduction in some cases of only 25 to 33 per cent. Furthermore, concessions larger than are necessary may sometimes have to be given for concessions by foreign countries, because the concession of the minimum rate must be given to all countries entitled to any concession whatsoever.

Greater bargaining power is attained under the general-and-con-

## 248 International Trade and Commercial Policy

ventional system, since there is no all-round, set difference between the general and the conventional duties, as is true of the maximum-and-minimum system. Reductions from the general schedule may be as great as necessary for each article, but need be no greater. Proponents of this system also claim that the general-and-conventional tariff gives greater tariff stability than the maximum-and-minimum. Under the former, the minimum rates continue in effect until the expiration of the treaty, and a treaty is usually concluded for a definite number of years and is automatically renewed for a year at a time until one of the parties makes known its intention to terminate it. The commercial treaty of 1828 between Prussia and the United States, for example, lasted until the two parties went to war in 1917. Proponents of the maximum-and-minimum tariff counter, however, by stating that tariffs under this form may be just as stable as under the general-and-conventional form, and actually were, among European tariffs prior to 1914. Another argument advanced in favor of the general-and-conventional system is that it tends to dissociate tariff problems from domestic politics by making considerable use of experts in treaty making. On the other hand, it is sometimes argued that this form of tariff may at times work against the best interests of a nation if economic conditions change during the period of the treaty.

No general judgment in favor of one or the other of these two forms is possible, because their merits must be weighed relative to the objective in view. Countries committed to high protection seem to prefer the maximum-and-minimum form, since this form gives the government more freedom in shaping its policy of protection; while countries which favor low duties and seek to extend their foreign trade will choose the conventional form, which affords greater scope in bargaining. A nation's traditions and institutions will also be important factors in determining the form of tariff chosen. It would be difficult to imagine the adoption of a general-and-conventional system by the pre-1932 United States, because of Congress's jealousy of its tariff-making powers, its disinclination to grant broad discretionary powers to the executive, and its reluctance to ratify trade treaties, once they had been negotiated. Even the Reciprocal Trade Agreements Act of 1934, which gave the President the power to make agreements with foreign countries and provided that these

treaties should go into effect without Congressional approval, carefully restricted the discretion of the President.<sup>1</sup>

Regardless of which of these two systems is adopted, the chances are excellent that it will later be modified either by international commitments or by legislation induced by peculiarities of the commercial situation. Prior to the first World War, Germany, one of the leading exponents of the general-and-conventional form, fixed minimum rates below which no conventional rates might be set. Spain set two schedules of duties in her tariff of 1877, a maximum and a minimum. Later, modifications of the minimum schedule were made in favor of certain countries and were incorporated into a third, or conventional, schedule. Finally, still lower rates were granted Portugal by the reciprocity treaty of 1893, thus establishing a fourth schedule.

*The Triple-Line Tariff.* The triple-line tariff is almost invariably an outgrowth of the double-line tariff, and originates from the desire to discriminate more closely between different countries than is possible under a double-line system. The third schedule may be based on the minimum, or conventional, rates and represents a percentage reduction therefrom; or it may be based on the maximum, or general, rates, in which case it will lie somewhere between the other two schedules.

This form is common among the tariffs of colonial powers and the tariffs of colonies and dominions. In the British Empire, it is found in the tariffs of Canada, Australia, and New Zealand. All three schedules of the Canadian tariff are enacted by law. The rates of the general schedule are applied to imports from all countries not entitled by law or treaty to special treatment. The intermediate schedule may be applied to the products of any country in consideration for satisfactory benefits. This schedule is intended to be an instrument of negotiation. The British preferential rates, the lowest of the three, apply only to imports from the British Empire. The preferential tariff is designed, obviously, to encourage trade among members of the Empire—at the expense of trade between members of the Empire and non-Empire countries. The Trade Agreements Act of 1934 endowed the United States, in effect, with a multiple-tariff system. Not all countries were granted the reduced rates of

<sup>1</sup> This act is discussed in detail in Ch. XVII.

## 250 International Trade and Commercial Policy

the reciprocal trade agreements, so that the general rates of the Hawley-Smoot Act of 1930 continued to apply to some countries. A third, and preferential, list of duties on certain commodities applied to Cuba.

The chief advantage claimed for the triple-line tariff, namely, that it makes possible a higher degree of discrimination and consequently affords greater bargaining power than the double-line tariff, also constitutes a weakness of this system. For the preferential treatment among the British Dominions in favor of the United Kingdom has been the subject of considerable complaint by nations which consider this discrimination contrary to the requirements of their most-favored-nation agreements with the United Kingdom. The administration of the preferential range of duties also presents difficulties, as it is not always easy to tell whether only the classes of goods to which preference is supposed to apply are enjoying it. Administrative obstacles to trade increase under the triple-line tariff because it becomes necessary to secure evidence of the origin of goods eligible for preferential rates. The triple-line tariff may, moreover, fail to enlarge the international movement of goods, for there is a strong temptation to temper preferential advantages with protection to home industry by raising intermediate rates rather than by lowering those in the preferential schedule.

The years since 1931 have witnessed an increase in the number of countries employing triple-column tariff systems. Employed, up to that time, chiefly by the nations of Continental Europe, they have since been widely adopted elsewhere, particularly by the smaller nations of Latin America.<sup>2</sup> While the newer laws, like the older ones in force in European countries, are devised to make possible finer discriminations among different countries, many of the new laws differ from the older ones in that they make the basis for differentiation the state of the balance of trade with each country from which goods are imported. The system established by Cuba in 1935 affords a good illustration of this new adaptation of an old instru-

<sup>2</sup> Definite statutory changes in this direction have been made by Colombia, Cuba, Ecuador, Guatemala, Haiti, El Salvador, and Uruguay, while certain other countries south of the Rio Grande have applied differential tariff treatment, in practice, to an increased extent. Cf. U.S. Tariff Commission, *Extent of Equal Tariff Treatment in Foreign Countries* (1937).

ment. Maximum rates, 100 per cent higher than minimum rates, were to be applied to countries whose purchases from Cuba amounted to less than one-fourth the value of their sales to Cuba. On imports from countries whose purchases from Cuba amounted to more than one-fourth, but less than one-half, of their sales to Cuba, intermediate rates, 25 per cent higher than minimum rates, were to apply. Minimum rates were to apply only to imports from countries whose imports from Cuba were at least half the value of their exports to Cuba, and to certain raw materials and other articles of prime necessity, regardless of their origin. This system obviously constitutes merely another sacrifice on the altar of the great god, Bilateralism.

### KINDS OF DUTIES

Tariffs differ from one another not only in the number of schedules constituting the tariff, or in the method by which rates are set, i.e., by statute or by treaty, but also in the kind of duty used. There are two basic types of duties—*ad valorem* and *specific*. Duties calculated as a fixed percentage of the price of an imported article are known as *ad valorem* duties; those levied as a fixed sum of money on each physical unit—pound, yard, gallon, dozen, bushel, etc.—of the imported article are called *specific* duties. Sometimes both *specific* and *ad valorem* duties are imposed on an article; such combinations are known as *compound* duties. Under the United States Tariff Act of 1930, the duty on lemons is *specific*, \$0.025 per pound, while that on dates is *ad valorem*, 35 per cent of their value; wool yarns valued at not more than \$1.00 a pound have to pay a *compound* duty, \$0.40 per pound plus 35 per cent of their value.

*Ad Valorem Duties.* The chief advantage of *ad valorem* duties is that the burden of the tax remains unchanged regardless of market-price fluctuations. The amount of the duty increases, or diminishes, according to the rise, or fall, in the price of the imported commodity—the rate of the duty is constant. Also, they are equitable when properly applied, since the finer, and therefore higher-priced, forms of a particular commodity pay a proportionally higher duty than the cruder grades, which sell for a lower price. The burden of *ad valorem* duties, moreover, may be more clearly expressed; a duty of 25 per cent is more readily comprehended than one of eight shil-

## 252 International Trade and Commercial Policy

lings per hundredweight. And international comparisons of the heights of tariffs are more easily made when the duties are ad valorem than when they are specific.

There is, however, one serious disadvantage in the use of ad valorem duties: every imported commodity subject to a duty must be evaluated. Difficult questions face those charged with the task of evaluation. Shall the value for purposes of levying the duty be the price at the place of purchase, the price at the port of departure, or the price at the port of entry? Shall it include the cost of packing, and the cost of transportation? Shall it be the invoice price, or a specially declared value? The price is subject to considerable fluctuation, even during a single day, and also varies according to the amount purchased, the quality of the commodity, the period of credit granted, and the credit rating of the purchaser. There is, too, a strong temptation for importers to undervalue goods imported in order to escape the full payment of duties. To overcome these difficulties and to approximate a reliable valuation, a large number of expert officials is required as well as a complicated system of controls and penalties. The ascertainment of a fair value frequently involves checking the declared value against the price in the exporting or importing country. Oftentimes, too, in order to achieve the same end, the state exercises its right to purchase the goods at the declared price, or to examine the books of the firm, or to demand invoices certified as correct by its consuls in the country of export. These checks and controls cause delays, and make the process of evaluation complicated and costly. At best, a certain arbitrary element remains in assessed value.

For the purpose of computing ad valorem duties, there are three different bases upon which the values of goods may be determined. The United States is one of a small group of countries which base ad valorem duties almost exclusively upon the value at the place of exportation.<sup>8</sup> In most countries which employ ad valorem duties, however, rates are based on the value at the port of importation. Obviously, a 20 per cent duty is greater when it is based on import value than when it is based on export value, for the former includes

<sup>8</sup> Canada, Cuba, the Philippine Islands, Panama, Newfoundland, and the Union of South Africa follow the same practice.

transportation and insurance charges which are absent from the latter. The persistent demands from certain protected interests in the United States for a shift in the basis of valuing imports from foreign value to American value, i.e., the price in leading American markets, are a thinly disguised effort to secure additional protection. The United States Tariff Act of 1930 provides for a theoretical foreign value when the foreign, or export, value cannot be directly ascertained. This "United States value," as it is called, is found by first taking the market price of such, or similar, imported merchandise in the principal market of the United States, and then deducting from this price freight, duty, insurance and other charges, commissions, and profits, thus arriving at the probable foreign value. Since the law limits the allowance for commissions to six per cent and that for profits to eight per cent, the calculated "United States value" usually turns out to be higher than would have been the "foreign value," had it been ascertainable. Still another method is employed by some countries, e.g., Argentina, Bolivia, Paraguay, and Uruguay, which assess ad valorem duties not upon the actual value of particular shipments but upon arbitrary values officially assigned, purely for assessment purposes. Where these official values may be altered in case proof is given that they are wrong, the duties remain, in fact, ad valorem. But where such valuations cannot be challenged, and where rates are changed infrequently, the duties become, in effect, specific.

Finally, it should be pointed out that ad valorem duties provide a constant degree of protection only when prices abroad and at home change together. Actually, prices abroad can, and at times do, fall, or rise, farther and more rapidly than domestic prices. If, when ad valorem duties are based on the export price, the foreign price of an article falls relative to the domestic price, the protection afforded by ad valorem duties is diminished; while contrariwise, if the foreign price rises relative to the domestic price, the protection is increased. This means that protection decreases at the very time it is most needed, and increases when it is least needed. Basing the assessment on the import price does not avoid this variability of the protection afforded by ad valorem duties, because the import price is commonly determined by adding to the foreign price or invoice



## 254 International Trade and Commercial Policy

price a certain percentage to cover transportation and insurance costs; in other words, the import price tends to fluctuate with the export price abroad.

*Specific Duties.* Compared to ad valorem duties, specific duties are relatively easy to assess because it is not necessary to set a value upon the imported article. All that is required is to measure, weigh, or count the article. These physical properties are generally easier to determine than is the value, although under a highly specialized tariff complicated physical and chemical researches are often involved in their determination.

But there are definite disadvantages in specific duties. First, the burden of such duties varies with variations in the price level. When prices are rising, the duty, being fixed in amount, becomes a smaller percentage of the value of the article, and therefore less protective; while, when prices are falling, the percentage of protection becomes greater. Some governments have made allowances for this in times of inflation by stating duties in terms of fixed amounts of gold. This expedient obviously fails to remedy the difficulty when the value of gold itself is falling. In the period of rising prices following World War I, France, which employed specific duties, met the difficulty by employing "coefficients of increase." These coefficients measured the rise in prices, and were used as multipliers of the old duty in order to obtain the duty which should apply at the higher price. If a tax of \$1 were levied upon a commodity originally priced at \$3, a doubling of the price of the article would cut the percentage of protection in half. But by multiplying the old duty by the "coefficient of increase," in this case 2, the duty would be raised to \$2, and the protection would be maintained at 33% per cent.

Second, specific duties are regressive in their effects, since they tax the coarser and cheaper grades of a commodity proportionally higher than they do the finer and more expensive grades. This disadvantage may be obviated by adopting an elaborate and minute tariff classification which varies the amount of the duty with each special feature of the article that affects its value. Cloth, for example, may be classified according to the number of threads per square inch, yarn according to its fineness. The classification may even be made according to the value of the article, as in the American Tariff of 1922, which imposed a duty of \$0.18 each on imported

razors valued at less than \$0.75 a dozen, \$0.25 each on those valued at from \$0.75 to \$1.50 a dozen, \$0.30 each on those valued at from \$1.50 to \$3.00 a dozen, and so on. Such specialization makes the tariff schedules longer and more complicated, of course, and increases the possibility of disputes over the proper classification of any particular import. Still another method of overcoming the regressive effects of straight specific duties is the use of compound duties: the basic duty is a specific duty, but it is supplemented by an ad valorem duty.

For certain goods, specific duties are patently unadaptable. This is true of antiques and works of art, for which assessment according to any physical property would be grossly inadequate.

Most countries employ specific duties. These duties are largely used on the continent of Europe and in many Latin American countries. Ad valorem duties are the basis of the tariffs of Great Britain, the British colonies and dominions, and some South American countries, but they have probably reached their highest development in the United States, although here many specific duties are also found. Japan, also, makes wide use of both types. Probably a compromise which makes use of both types of duties is the most satisfactory. Specific duties would be applied to standardized articles whose classification is easily identifiable, such as tin, wheat, and cotton, and ad valorem duties would be applied to those unstandardized articles which cover a wide range of qualities and whose qualities are in a constant state of flux. The latter would be largely manufactured goods.

*Alternative Duties.* In some tariff schedules provision is made for the imposition of *either* specific *or* ad valorem duties, in order to preserve a minimum level of duties. Where certain articles are subject to a specific duty, it may also be stipulated that these duties shall in no case be less than a certain ad valorem rate. Thus, if the price rises, so that the specific duty is less than this minimum percentage, the higher ad valorem rate applies. And where an ad valorem rate is imposed, it may at the same time be provided that under no circumstances shall less than a specific amount, per physical unit, be paid. The United States Tariff of 1930, for example, provides (Par. 223) that "Plate, cylinder, crown and sheet glass . . . when made into mirrors exceeding in size 144 square inches, and

## 256 International Trade and Commercial Policy

not exceeding 384 square inches, shall pay 15 cents per square foot; provided, that none of the foregoing shall be subject to a less rate of duty than 45 per cent ad valorem.”

### TARIFF CLASSIFICATION AND SPECIALIZATION

Since modern tariffs tax the various imported goods at different rates of duty, the tariff must enumerate and describe the various goods subject to duty and arrange them according to some particular classification. The classification of goods into a customs nomenclature may be established (1) according to the height of the duty (e.g., those goods taxed below 25 per cent ad valorem may appear in one class, those from 25 per cent to 35 per cent in another, etc.), (2) according to alphabetical order, or (3) according to certain attributes of the goods classified. Ecuador's customs law of 1916 is an example of the first type of classification. It consists of 58 classes. The first contains those goods whose importation is prohibited, the second those admitted duty free, and the remaining 56 those taxable at each class rate. This form of classification makes reference difficult for the merchant, because he is ordinarily interested only in rates on the particular goods he is importing, not in the relation of these to other rates. The Netherlands Tariff of 1924 and the Norwegian Tariff of 1927 employ the alphabetical arrangement. This type is simple, but takes no account of related commodities.

Under the highly protective tariffs of today, the most common arrangement is according to the attributes of the various goods. There are four principal attributes according to which such arrangements are made: (1) material origin, i.e., the grouping together of goods derived from the same physical substance; (2) actual content; (3) use or purpose; and (4) degree of finish, or stage of manufacture. The same tariff law may set up different schedules according to different bases, as does the United States Tariff of 1930.<sup>4</sup>

<sup>4</sup>The sixteen schedules of this act are:

- (1) Chemicals, oils and paints
- (2) Earths, earthenware and glassware
- (3) Metals and manufactures of
- (4) Wood and manufactures of
- (5) Sugar, molasses and manufactures of
- (6) Tobacco and manufactures of
- (7) Agricultural products and provisions

The segregation of dutiable articles into broad classifications, or schedules, fails, however, to provide that specialization which the wider scope of protection and the increasing specialization of modern production demand. Consequently, the main classifications are further subdivided. By means of specialization, goods which are in general similar, but are different in certain respects, are placed under different tariff items. The French and United States Tariff laws of 1930, for example, each contain more than 7000 separate items. The trend since the 1870's has been, and apparently still is, for tariff classifications to become more complicated and the individual items more numerous.<sup>5</sup> But despite the elaborate specialization of customs nomenclature, it is impossible to enumerate all the articles of commerce in a tariff. It is estimated, for instance, that there are over a million different articles of commerce. Tariff-makers have therefore had to resort to catchall clauses, which provide for the imposition of duties on articles not enumerated in the tariff.<sup>6</sup>

Due to the development of new articles, new processes, new uses, and adaptations of old articles, more detailed classifications in tariffs have become necessary in order to prevent actual discriminations. The more elaborate classifications often decrease the discriminatory effects of tariff rates. It is only through an elaborate and detailed

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- (8) Spirits, wines, and other beverages
  - (9) Cotton manufactures
  - (10) Flax, hemp and jute and manufactures of
  - (11) Wool and manufactures of
  - (12) Silk manufactures
  - (13) Manufactures of rayon or other synthetic textiles
  - (14) Papers and books
  - (15) Sundries
  - (16) Free list (alphabetical)

<sup>5</sup> This tendency is illustrated by the Italian tariff. In 1878 there were only 535 autonomous tariff items, but the number had increased to 766 in 1888, to 837 in 1895, to 1083 in 1910, and to 2777 in 1921. Besides the specialization which is set up in the tariff law, later treaties may increase the number of separate tariff items. See the memorandum submitted to the World Economic Conference, Geneva, in 1927 by Trendlenburg, *Customs Nomenclature and Customs Classification*, Publication of the League of Nations, II. Economic and Financial Section, 1927. II. 24.

<sup>6</sup> Such a catchall clause may be illustrated by the American Tariff of 1922. After enumerating beef at \$0.03 a pound, bacon at \$0.02, reindeer meat at \$0.04, together with a dozen other meats or meat preparations at specific rates, it carries a paragraph which reads: "Meats, fresh, prepared or preserved, not specially provided for, 20 per cent ad valorem."

## 258 International Trade and Commercial Policy

specialization that the inequitable and regressive effects of specific duties may be ironed out. Moreover, once protection is granted to any article, it may be discovered that discrimination among home producers can be avoided only by a careful segregation of the different stages of production and a grading of duties. A duty on raw wool to protect sheep raisers will necessitate a duty on yarn to protect spinners; this, in turn, will lead to a duty on cloth to protect weavers; and, finally, the higher price of cloth will lead to a duty on clothes in order to protect the tailoring industry.<sup>7</sup> The development of artificial silks, artificial rubber, plastics, etc., create problems of substitution and competition which compel further specialization of tariff items in order to avoid other types of discrimination.

More detailed tariff specialization may be the means of avoiding discriminations which would otherwise result from tariff bargaining. If, for instance, it is desired to have the same protection against imports of cotton textiles from countries A and B, but if, at the same time, it is known that the statutory rate will remain in effect against A, while the rate against B will be reduced by tariff bargaining, a careful classification of cotton textiles in the tariff law may produce an equalization of rates after the bargaining process is completed at

<sup>7</sup> When an import duty is imposed for the purpose merely of compensating the domestic producer for an import duty on raw materials used, or for internal taxes on his product, it is known as a *compensating* duty. Such a duty is not intended to be protective, but is designed simply to counterbalance the added costs imposed upon the home producer by government action and prevent them from penalizing the home producer in his competition with foreign producers. The compound duties on woolens in the United States tariff, first applied in 1861, illustrate the application of these duties. Under the Act of 1861, woollen cloths carried a duty of \$0.12 a pound plus 25 per cent ad valorem. The 25 per cent ad valorem duty was intended to protect the American manufacturer of woollen cloths from the competition of foreign manufacturers, while the specific duty of \$0.12 a pound was designed to compensate the manufacturer for the increased price he had to pay for raw wool, because of the \$0.03-a-pound duty levied on imports of the raw material to protect the American farmer. The specific duty on cloths was placed at four times the specific duty on raw wool, on the assumption that four pounds of wool normally entered into the making of one pound of cloth. But, since less than four pounds of wool was actually required, the overcompensation provided by the specific duty amounted to added, although disguised, protection to textile manufacturers. This system of compensating duties persisted in the wool schedule until it was swept away by the tariff revision of 1913. It was reincorporated in the Act of 1922.

the same time that it avoids the appearance of any unequal treatment in the original act.<sup>8</sup>

Although tariff classifications may sometimes be necessary to prevent discrimination between countries, they have at other times been used to effect such discrimination. If it is desired to discriminate in favor of a particular country, which amounts, of course, to discriminating *against* all others, without appearing to establish a preferential tariff, the commodity in question may be broken down into specialized classes, and one particular class, which could only be imported from the favored nation, may be selected for preferential treatment. A classic example of such discrimination is found in Germany's pre-1914 conventional tariff, Item No. 103, which granted tariff reductions on "large dappled mountain cattle or brown cattle reared at a spot at least 300 metres above sea level and which have at least one month's grazing each year at a spot at least 800 metres above sea level." Only cattle reared in Austria or Switzerland could qualify for admission to so select a group.

Tariff specialization has also been a means of limiting the effects of concessions granted under most-favored-nation treaties. With broad classes of goods grouped together and subject to a single rate of duty, reductions in duties granted to one country may be extended to countries which it was not intended to benefit. But through a specialization of commodities so detailed that every commodity, or class of a commodity, imported has its own individual rate, a reduction in duties resulting from bargaining with another country may be restricted to that country, provided that the country is the only supplier to the concession-granting country of the particular type of the commodity upon which reductions have been granted. For other countries, which under most-favored-nation treatment are entitled to the reduced duty, may not benefit from the reduction because they do not produce or export that particular type of the commodity. Duty reductions are more willingly granted and are more readily offered if their benefits are not obtained too cheaply by some.

<sup>8</sup> Cited by T. W. Page, *Memorandum on Discriminatory Tariff Classifications*. Publication of the League of Nations, II. Economic and Financial Section, 1927, II. 27.

## 260 International Trade and Commercial Policy

It is probably true that serious discriminations by classifications are not common. Page concluded in 1927 that the increasing detail of European tariffs has not found its chief motive in the desire to evade most-favored-nation pledges and that the competition between the articles distinguished is not usually close.<sup>9</sup> The complicated modern tariff has not been created at one stroke, but has developed over a long period through continuous alteration. Every separate item has its history.

There can be little doubt, however, that the increasing complexity of tariff classifications is proving to be a growing hindrance to international trade.

As the specifying of goods gets more and more detailed and complicated, the application of the tariffs by the Customs officials will grow more difficult. The demands made on their technical knowledge will grow excessive. The fine distinctions established between the different classes of goods will make Customs inspection a more and more complicated and lengthy process. The consequence will be that international trade will be faced, apart from the loss of time, with a continual increase in its expenses. The burden already imposed upon the administration and upon trade by the technical application of the numerous duties will, with the growing complications of the tariffs, become more and more oppressive . . . the differences in tariffs constitute a severe obstacle to trade and industry, not only because the exporter must be acquainted with the different tariffs, base his calculations thereon and make his declarations on that basis, but because the manufacturer is obliged to adapt his business to the complicated provisions of the different tariffs and to avoid components, such as single silk threads, for example, which would render his goods subject to a higher duty in a particular state. The variety of schedules therefore hinders the rationalization of production.<sup>10</sup>

Realizing the deleterious effects of diverse tariff classifications upon world trade, the World Economic Conference of 1927 demanded a simplification and standardization of tariff nomenclature. In response to this demand, the League of Nations set up an international committee of experts to work out a uniform scheme of nomenclature. It was hoped that the standardized nomenclature

<sup>9</sup> *Ibid.*, p. 7.

<sup>10</sup> Trendlenburg, *Customs Nomenclature and Customs Classification*, pp. 11, 19.

## The Content and Form of Tariff Laws. Bounties 261

drawn up by the committee might be widely adopted and that the nations accepting the standardized classification would agree not to create any further divisions or sub-divisions. The report has met with no response. And as one writer dolefully reflects, "We cannot assume that Protectionism will be outwitted by such a manoeuvre."<sup>11</sup>

### MEASURING THE HEIGHTS OF TARIFFS

Attempts are sometimes made to measure the heights of tariffs. Such measurements are generally sought for the purpose either of making international comparisons or of comparing the height of a particular country's tariff at two different times. During the presidential campaign of 1932, for instance, Republican speakers tried to defend the Hawley-Smoot Act of 1930 by proclaiming that it had resulted in but slight increases in rates—from an average ad valorem rate of approximately 13.7 per cent to one of about 14.5 per cent.

The method there employed for measuring the height of the tariff was apparently to divide the total amount of duties collected by the total value of the goods imported. But this method is quite unsatisfactory. For the more protective duties become, the fewer will be the dutiable goods which are imported, and the larger will be the proportion of remaining imports which are duty-free. In short, if all duties were 100 per cent protective, only duty-free goods would be admitted, and the height of the tariff wall would, from this calculation, appear to be zero—an utterly fantastic and false conclusion! The same fallacy underlies those measurements which represent the value of duty-free imports as a proportion of the value of all imports. Here, again, the more restrictive tariff rates become, the more numerous will be the goods which are excluded, and the larger will be the percentage of duty-free goods which are actually admitted. According to this measurement, a free-trade nation, such as Great Britain before the first World War, which levies very low duties on several articles of wide consumption would appear to have a highly restrictive tariff. Obviously, both these methods overlook prohibitive duties and actually take into account only those duties at the lower extreme of the list.

<sup>11</sup> From Gottfried von Haberler, *The Theory of International Trade*, p. 340. By permission of The Macmillan Company, publishers.



## 262 International Trade and Commercial Policy

A more satisfactory method is to reduce all duties to an ad valorem base, compute an average of these ad valorem duties, and express this average duty as a percentage of the average value of all dutiable goods, including goods subject to prohibitive duties. But in applying this method of measurement certain difficult problems must be faced. The conversion of specific duties to ad valorem duties is frequently difficult because the conversion involves ascertaining the value of the article, and the value may not be known, or there may not be a uniform market price. The significance of the resulting percentage will, moreover, be obscured in many instances by the influence which the duties themselves exert upon the prices of the articles. Where, for example, the increase in a particular duty results in a decline in the export price of the commodity and a rise in the imported price smaller than the increase in the duty, the restrictive effect of the duty will be exaggerated. Again, every duty cannot logically be given the same weight in the average, for some goods are much more important in trade than others. Wool, for example, is a much more important article of international commerce than artificial teeth. The only way to take this greater significance of wool into account is to allot it a greater weight in the average than artificial teeth. But the adoption of weighting raises another problem—that of the basis upon which weights are to be chosen. To choose weights according to the shares of the different goods in the country's imports will again minimize the contribution of very high duties; because, when a duty becomes completely prohibitive, its weight in the average will become nil. It will be better to base weights upon the respective shares of the goods in total world trade, or upon the volume of production in one or more countries. Even these shares, however, will be considerably influenced by the heights of the duties.

A similar difficulty faces the selection of the goods to be included in the index. Whether these are chosen upon the basis of their importation into a given country or of their entry into world trade, the fact remains that once a duty becomes prohibitive, the commodity upon which it is levied ceases to influence the index. Once a duty becomes prohibitive, further increases are irrelevant.

In any measurement, it is necessary to define clearly what it is that one is trying to measure. If this be the relative degree of pro-

tection provided by different tariffs, it is not enough to reduce the various duties to one average ad valorem duty, even though the aforementioned difficulties could be satisfactorily resolved. For the same ad valorem duty may provide a much greater degree of protection for one country than for another. An average ad valorem rate of 25 per cent may be truly prohibitive for a country whose costs, for the goods in question, average only 20 per cent higher than in the exporting countries, while the same 25 per cent rate would furnish no protection to domestic production in a country whose costs average 50 per cent above those of the exporting countries. Likewise, an average level of duties of 25 per cent for a particular country may be more protective at one date than at another. Furthermore, the extent to which imports are curtailed by a tariff does not necessarily provide a reliable index of the degree of protection, because where the demand for a commodity is elastic the tariff will lead to a sharp curtailment in consumption.

Perhaps what is more frequently desired is a measure of the degree of obstruction to trade created by a tariff. Some writers have pointed out that for this purpose a single-index tariff for a country is insufficient, because a particular tariff act may impose severe restrictions upon the types of goods imported from certain countries, while leaving virtually undisturbed those types imported from others. Consequently, it has been suggested that many tariff indices be computed for each country, one for each country from which it imports. In the *Survey of Overseas Markets* of 1925, separate indices were calculated for the tariffs of the most important countries on British exports only. Probably the most that can be said for any tariff index, however carefully constructed, is that it may reveal in a rough way the degree of liberalism of a country's trade policy.<sup>12</sup>

### BOUNTIES

Tariffs are not the only device employed by nations to implement a policy of protection. Another means of accomplishing the same end, commonly used in the seventeenth, eighteenth, and nineteenth centuries and revived by some countries after the first World War,

<sup>12</sup> For a more complete discussion of tariff indexes, see Haberler, *op. cit.*, pp. 355-359, and R. A. Hodgson, *An Introduction to International Trade and Tariffs*, pp. 131-134.

## 264 International Trade and Commercial Policy

is the bounty. Bounties, also known as subsidies or subventions, consist of grants or allowances by the government to firms in the protected industry. They may be direct, i.e., cash payments from the public treasury, or indirect. Examples of indirect bounties are special, low freight rates on goods destined for export, exemption from taxes, loans at rates of interest well below the market rate, the granting of monopolies, and the awarding of mail contracts to domestic shipping interests at extremely generous rates. Bounties may be granted either upon the act of production or upon the act of exportation.

During the period of mercantilism, bounties were a common instrument of economic policy among the nations of western Europe. Frederick the Great and Colbert both made extensive use of bounties to nurture manufacturing in Prussia and France, respectively. Maria Theresa subsidized textile works in Bohemia and porcelain plants in Vienna. In order to build up her merchant marine in the face of stiff competition from the Dutch, England granted bounties on whaling and fishing boats and their catches, big ships, sailcloth, rope, silk, and linen. Indigo cultivation flourished in the British colonies in North America on a bounty of sixpence a pound, first granted in 1748, but it became unprofitable after the Revolution brought the grant to an end. Most of the other bounties granted to colonial products, e.g., those on silk, flax, naval stores in the northern colonies, hemp, and potash, met with little success. Many bounties in other countries survived into the nineteenth century, and even in the latter half of the nineteenth century when trade was relatively unshackled in western Europe, Austria-Hungary, Germany, and France granted bounties on sugar.

After the first World War, subsidies became more prevalent, even in Great Britain. After compulsory cartelization of the British coal-mining industry, the British Government paid a price-equalizing subsidy on exports of coal. Most of the British subsidies, however, have been confined to agricultural commodities, or their direct derivatives. In 1925 a sugar act was passed which provided for the payment of bounties to producers of home-grown beets, and in 1932 provision was made for a wheat subsidy. The Wheat Act provided for a deficiency payment to wheat-growers, equal to the difference between the average selling price of British-grown wheat and 10

shillings per hundredweight. But the full deficiency payment was to be made on not more than twenty-seven million bushels; in years in which the domestic production of wheat exceeded twenty-seven million bushels, there was to be a graduated reduction in the deficiency payment. Germany had an elaborate system of export subventions in the inter-war period. Indirect subsidies were granted up to 1934, but thereafter these were supplanted by direct cash subsidies. Direct and indirect subventions upon merchant shipping have been made by many nations, including the United States. The help which a merchant marine may be expected to render in time of war and in building up foreign markets in time of peace has been the chief consideration in granting subsidies to shipping.

Alexander Hamilton, who advocated protection for young industries in the United States, favored bounties as a more efficacious instrument of protection than import duties and one that at the same time produces fewer harmful effects than the latter. He advanced four reasons for his preference. (1) Bounties are more positive and direct than tariffs in stimulating and upholding new enterprises; (2) they do not cause a rise in the price of the protected article, or, where they do cause a rise,<sup>13</sup> it is less than in the case of an import duty; (3) they do not tend to produce scarcity; and (4) they do not discourage the export of manufactured goods as do import duties when they are levied upon imports of the raw materials of export industries.<sup>14</sup> But Hamilton was careful to point out that, whereas bounties to new undertakings were justifiable, the wisdom of continuing them for long must always be open to question, because of the presumption that natural and inherent impediments to the success of such enterprises exist.

Where a nation has become definitely committed to a policy of protection, Hamilton's preference for bounties in lieu of import duties must be admitted to be sound. When an industry receives a

<sup>13</sup> For example, where the funds to pay the bounty are raised by means of a duty on imports of the article. A duty of one per cent on the foreign article, used to pay a bounty on the domestic article, will have an effect equal to that of a two-per-cent duty, exclusive of the bounty. The one-per-cent import duty is liable to raise the price of the article by only one per cent, a two-per-cent duty by two per cent.

<sup>14</sup> *Report on Manufactures*. Reproduced in Taussig's *Selected Readings in International Trade and Tariff Problems*, pp. 473-476.

## 266 International Trade and Commercial Policy

direct bounty, the public can clearly see that its protective policy is costly and just what the cost is. The cost of import duties is, unfortunately, hidden from the public, for all that consumers are usually aware of is the final price which they must pay for a good, and they rarely realize that this price contains a sizable tax. If the cost of protection were more generally recognized, the public might be less prodigal in granting protection and more critical of the continuance of burdensome duties which have been in effect for many years. Bounties make possible, furthermore, a more equitable distribution of the costs of protection than do import duties. The latter are borne directly by the consumers of protected goods; and if the taxed goods are widely consumed, the tax becomes regressive. But where protection is imposed to nurture industries deemed essential to national defense, to diversify the population, or even in the hope of reducing unemployment, the consumers of the taxed articles are not the only ones who may be expected to enjoy the anticipated benefits. Nor are they usually the ones best able to bear the burden of the tax. Bounties are paid out of the public treasury, however, and therefore permit as equitable a distribution of the burden as the legislators can, and do, devise in the general tax structure.

*Export Bounties.* Export bounties were one of the chief instruments of mercantilist trade policy. Since they tend to promote exports, improve the balance of trade, bring gold into the country, and benefit home producers, they were well adapted to the mercantilist system.

England granted bounties on exports of grain for a century beginning in 1688; the amount of the bounty varied inversely with the home price. Ireland began to pay bounties on exports of linen in 1740 and continued them for nearly a century; her example was later followed by England and Scotland. The export bounties on sugar paid by the nations of western Europe in the second half of the nineteenth century have already been mentioned. After the international economic crisis of 1931, Germany made wide use of export subventions, both direct and indirect, in order to forestall a decline in her export trade, resulting from rising internal prices and foreign exchange depreciation by Great Britain and other competitor countries. Prior to 1934, German exporters were permitted to use a part of the foreign exchange which they obtained

from the sale of their exports abroad for the purchase of German bonds in foreign countries, where the bonds were selling at large discounts from par; they were then allowed to resell these bonds in Germany at par. This practice was permitted only in connection with export sales that could not be made at cost or above, and the selection of the recipients of this indirect subsidy was in the hands of the German Government. This plan was discontinued after 1934 in favor of a direct cash subsidy, the funds to be raised by "voluntary" contributions of industrial concerns through their respective trade associations. Subsidies on individual goods as high as 50 per cent of the invoice price are reported, and it is estimated that total subsidy payments were equal to 15 or 20 per cent of the total value of Germany's exports in 1935. Several of the plans advanced during the 1920's and 1930's for improving the lot of the American farmer have been based upon some form of an export bounty.

A special form of export bounty is the import certificate (*Einfuhrscheine*), adopted by Germany in 1894 and continued in effect up to the first World War. This system provided for the issuance of an import certificate to German exporters of certain agricultural products in quantities of not less than 500 kilos, which entitled the holder to import within a certain period a quantity of specified kinds of products to a value corresponding to the "customs value" of the certificate without payment of an import duty. The "customs value" of the certificate was fixed according to a special list. The list of commodities to which the certificate permitted free importation included grain, petrol, spices, and cocoa. These certificates could be sold, and, when sold, tended to bring a price about equal to the amount of the duty it saved the importer. Germany reestablished the import certificate system in 1926 and extended it to other commodities.

*Effects of Export Bounties.* An export bounty will cause the price of the exported commodity to fall in foreign markets, because of the larger supply in those markets, and will bring about a situation in which the domestic price is higher than the foreign price by the amount of the bounty. This does not mean, however, that the decline in the foreign price will be equal to the bounty. The increase in exports will cause an expansion of domestic production, and a diminution of production abroad. There will be an immediate rise

## 268 International Trade and Commercial Policy

in the domestic price because a portion of the domestic supply will be exported. But when sufficient time has elapsed to permit plant capacity to be enlarged, the domestic price will return to its former level, if a larger output can be produced at the former unit costs. If the larger output can be produced at a lower unit cost, the domestic price will fall, and the decline in the foreign price will be greater than the amount of the bounty. If diminishing returns are encountered, costs will rise, and the fall in the foreign price will be less than the amount of the bounty.

The maintenance of a differential between the foreign and the domestic price, equivalent to the bounty, depends, however, upon the prevention of the reimportation of the subsidized exports. This may be accomplished by imposing an import duty equal to the bounty. If no corresponding import duty is imposed, and if the combined transportation costs to and from the foreign country are less than the bounty, reimportation will occur. The reimports will force down the domestic price and will establish a price differential between the two markets smaller than the amount of the bounty—a differential just equal to the round-trip transport costs. The export bounty then becomes, in fact, a bounty on production. The domestic price will fall, and domestic consumption will increase.

In appraising export bounties, Haberler's distinction between pure export bounties and compensatory export bounties is a helpful one.<sup>15</sup> Pure export bounties are granted simply to encourage particular branches of production, although these branches find themselves in no way handicapped, relative to their foreign competitors, by special taxation, by high monopoly prices for their materials and equipment, or by any similar burden. Compensatory export bounties are granted solely to counteract some burden of this sort.

The effects of pure export bounties are similar to those of tariffs. Pure export bounties tend to divert productive resources away from those industries in which a nation's comparative advantage lies. They induce an economy either to produce goods which could be obtained at less expense abroad, or to expand the subsidized industries beyond the point most profitable to the economy. Unlike tariffs, they are a gift to the foreigner, provided they are not in-

<sup>15</sup> *Op. cit.*, pp. 321–322.

## The Content and Form of Tariff Laws. Bounties 269

tended to be in effect only long enough to destroy his industries.

Compensatory export bounties, on the other hand, may find logical justification. This is true where they are granted merely as a refund of an internal consumption tax upon that portion of the supply to be exported; or to offset import duties collected on raw materials or instruments of production employed in the manufacture of export goods; or by monopolies or combinations making producers' goods to export industries which are users of these producers' goods and are charged by the monopolies higher prices than are charged to foreign competitors of the finishing industries—in other words, where the monopolies are indulging in dumping. An export bounty that is designed merely to counteract an import duty imposed by another country and to reestablish the conditions which would exist under free trade is not so easy to justify. In this instance, the exporting country, in effect, pays the import tax to the foreign country.

The advantages which an export bounty might be expected to give domestic producers in export markets may fail to materialize because of the imposition of equalizing duties by foreign countries. These additional duties, or surtaxes, imposed by an importing country for the purpose of neutralizing bounties or favors conferred upon certain imported articles by the governments of, or cartels in, the exporting countries are called *countervailing* duties. Frequently, an export bounty discourages the production of an article in the importing country and renders ineffective import duties set up to foster its production there. A countervailing duty will restore the protection originally provided in the tariff law. The American Tariff Act of 1890 included provisions for special additional duties on the bounty-fed beet sugar of many European countries. Since 1897, United States tariff laws have provided that any dutiable article which receives a government bounty shall be subject to a corresponding countervailing duty upon its importation into this country. By the Tariff Acts of 1922 and 1930, countervailing duties were extended to apply to dutiable goods receiving bounties from private sources, either individual or corporate, as well. These duties are intended merely to reestablish the amount of tariff protection originally provided.



## 270 International Trade and Commercial Policy

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## *Arguments for Protection*

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### FREE TRADE

The main argument for free trade has been developed at length in preceding chapters. It is simple and direct: it rests solidly upon the principle of the division of labor. Each individual will obtain goods more easily and in greater abundance by specializing in production and exchanging his surplus for the surpluses of other individuals than he will by producing for himself all the goods that he consumes. This is true whether the individuals live in the same village or in widely separated regions. The same reasoning which demonstrates the advantages of trade between the doctor and the farmer, between Massachusetts and California, and between New England and the agricultural Middle West also makes out a strong case for untrammelled exchange between the United States and France, between England and India. In either case, freedom of exchange promotes the maximization of the incomes of the participating individuals, regions, and nations from the limited resources available.

### PROTECTION

Although the free trade argument is simple and precise and its logic unassailable, tariffs, quotas, prohibitions, exchange controls, and the other devices of protection continue to increase their obstructive effectiveness. Unlike the doctrine of free trade, the doctrine of protection rests upon no single and clear cut foundation—provided the basic social philosophy is not one of autarchy. Instead, a host of arguments has been developed in support of protection, arguments frequently inconsistent with one another and advocating

## 272 International Trade and Commercial Policy

the application of protection at different times and under quite different conditions. Even if a particular argument for protection is accepted without reservation, the acceptance of the doctrine of protection, again unlike that of free trade, offers no easy answer to the questions under exactly what circumstances the policy should be applied and how high the tariff rates should be.<sup>1</sup>

Many of the arguments in favor of restrictions upon trade are founded on popular, but obvious fallacies, such as the crudely mercantilistic philosophy which regards exports as good but imports as bad. And, strange as it may seem, it is largely upon these crudely fallacious arguments that the political strength of protectionism has been built. The more logically substantial arguments have found little understanding among the masses. Some of the arguments claim that only by means of protection can the social income be maximized; others admit that protection will reduce the national income but maintain that it will compensate for this loss of income by achieving certain other desirable objectives, e.g., fostering industries essential to the national defense, bringing about a desirable diversification of social classes, or forcing other nations to reduce their tariff walls. The leading arguments for protection are subjected to critical appraisal in this chapter and the one following.

### THE HOME MARKET ARGUMENT

One of the most glaringly fallacious arguments for protection is that which urges the erection of tariff barriers against one or several commodities in order to stimulate the growth of new industries at home, thereby increasing domestic purchasing power and domestic sales of other home products. A new and additional market, it is claimed, is created for home producers. This argument has been commonly employed in the United States as an appeal to the farmers to support an industrial tariff; it is to be found as late as 1924 in the Republican national platform. If, for example, protection is granted to the textile industry in a country where the industry does not now exist, the argument runs, new textile mills

<sup>1</sup> The theoretical justifications for protection are made chiefly with regard to customs duties, but they would be as applicable in most cases to other methods of trade restriction.

will be erected in the country, textile workers will buy cereals, meats, and dairy products, and the increased demand for agricultural products will benefit the farmer.

The fallacy of the argument lies in the presumption that there will be an *increased* demand for domestic products. Protection does not create an additional market; it merely substitutes a domestic market for a foreign market. It is true that protection will lead to the establishment of a new home industry. But, since our imports from foreign countries provide foreigners with the purchasing power with which to buy our exports, the exclusion of foreign wares from our markets will deprive foreign consumers of the means of purchasing our products in an amount equal to the reduction in our imports. So, while workers in the new domestic industry may buy more from other domestic industries, foreigners will be forced to buy less than formerly from the old domestic industries. There will be no net increase in sales for domestic industry as a whole. The home market gained merely replaces the foreign market lost; it does not create an additional market.

Not only is no additional market developed, but in addition domestic consumers are compelled to pay higher prices for the products of the protected industries. In this respect they are worse off than they were before the tariff was applied. The loss to the nation occasioned by the policy of protection results from shifting factors of production from fields of activity where their productivity is high to fields where their productivity is low; the very need for protection indicates the lower productivity of the factors in the protected industries. The factors that are employed in the new, protected industries could provide more of the protected goods for the nation by producing the goods formerly exported and importing the now protected goods than they can by producing the latter directly.<sup>2</sup>

The objection may be raised that this refutation of the home market argument is founded upon the presumption that exports will decline *pari passu* with the decline in imports, and that, while one may acknowledge that equilibrium in any country's balance of

<sup>2</sup>Of course the factors utilized in the protected industries may have been unemployed. This case is examined below in connection with the tariff argument for the reduction in unemployment.

## 274 International Trade and Commercial Policy

international payments requires the equality of total debits and total credits, one may nevertheless ask why the adjustment to the reduction in imports will not occur in some account, or accounts, other than merchandise exports, so that the latter need not necessarily undergo any reduction. After all, the balance of international payments includes services, loans, interest and dividends, and gold, as well as goods. And while the gap in the balance sheet caused by the smaller payments to foreigners must be made up in *some* way, it could conceivably be made up by an increase in any debit item, by a decrease in any credit item, or by any combination of the two.

The logic of this objection cannot be denied. Nevertheless, an investigation of the relative sensitiveness of these other accounts to a decline in imports discloses a strong probability that the adjustment will be made by an equivalent decline in merchandise exports.

There is little reason to expect any significant adjustive response from any of the service items. Insurance, shipping, and banking charges are closely geared to the volume of goods exchanged, and smaller merchandise imports would hardly induce a nation to make *larger* purchases of these services. Quite the contrary. And without a great reduction in exports, sales of similar services to foreign importers would not decline enough to effect the necessary adjustment. In other words, if exports did not decline at all, the nation should expect to sell almost as much of such services to other nations as formerly. The volume of both tourists' expenditures and immigrant remittances is governed by forces largely independent of such changes in merchandise movements, so that these service items can hardly be expected to absorb the change. And interest and dividends are not likely to be directly affected because they are chiefly determined by previous international movements of capital.

If adjustment is to be made by means of loans, i.e., capital movements, either the tariff-levying nation must reduce its borrowings from abroad, or it must increase its loans to other nations. Obviously it cannot reduce its borrowings unless it is already borrowing. Furthermore, since international movements of capital are primarily dependent upon differences in interest rates in different centers,

barring those panicky flights of capital precipitated by disturbed political and diplomatic situations, altered capital-flows will hinge upon changed national credit policies, or altered demand-supply conditions in the capital market. But there is little basis for predicting how, if at all, the mere imposition of a tariff will affect interest rates. The expansion of the protected industry may increase the demand for capital in the tariff-levying country and thus cause a stiffening of interest rates there; but this will lead to an *inflow* of capital, not to an *outflow*, as adjustment demands. In the short run, however, discount rates will be dominated by central bank policy, and today these are generally manipulated to encourage the stability of general business conditions.

It must be admitted that the deficit in the debit column of the international accounts will be met immediately by an inflow of gold, a building-up of bank balances in foreign centers (an export of short-term capital), or both. But neither of these short-term adjustive forces can continue to operate indefinitely. The excess of offerings of foreign exchange over the demand for exchange, which is the source of the larger bank balances abroad, will force down the rate of exchange; and whether gold flows in or not, exports of merchandise will suffer. If gold flows in (assuming gold standard conditions), prices will be forced upward, exports will decline, and imports will increase. If the country is not on the gold standard, exports will nevertheless be curbed and imports will be stimulated, but as a result of the fall in foreign exchange rates rather than of an inflow of gold and an adjustment of prices.

Thus, although a contraction of imports caused by a tariff need not lead immediately to a corresponding curtailment of exports, this result is to be expected eventually. An inflow of gold or an outflow of short-term funds can be expected to be only a temporary expedient for meeting the import deficit, and will probably lead directly to smaller exports. The necessary adjustment in the balance of international payments is not likely to occur through alterations in any of the international accounts other than exports of goods, capital, or gold, except under most unusual conditions. There is, therefore, a high degree of probability that a reduction in imports will sooner or later lead to an equivalent reduction in exports.

## 276 International Trade and Commercial Policy

### PROTECTION OF THE WAGE LEVEL AND STANDARD OF LIVING

The most common, and to the man on the street the most effective, argument for protection is the one which insists that a country with a high level of wages must either have a protective barrier against imports of goods from countries with a lower wage level or see its wage level deteriorate to the level of the "pauper labor" abroad. While free trade with nations enjoying a standard of living as high as the American standard might be advantageous for the United States, the argument runs, unfettered exchange with Japan or China would only result in forcing the wages and standard of living of the American workman down to the level of the Oriental coolie's. Since American employers pay higher wages than do employers in Europe and Asia, it is reasoned that the production costs of the former must necessarily be higher. So, unless the prices of cheap foreign imports are raised by a tariff, or unless American wages are reduced, American products will be undersold in the domestic market. The American standard of living can therefore be maintained only by protecting the American workingman from the competition of lowly paid workers abroad!

The fallacy of this argument will be apparent to anybody who has mastered the analysis in Chapters V, VI, and VII. Economic theory discloses that labor tends to receive a wage equal to the value of its marginal product. High wages are the result of high productivity; they are not the cause of high prices, except where labor is ineffectively applied. Proof of this is supplied by the continuous exportation of goods from high-wage to low-wage countries. To argue that high tariffs cause high wages is to say that wages may be raised to any desired height merely by raising the tariff. But to believe that wages can be raised by raising the level of import duties is absurd. Wages depend upon the size of the marginal product of labor, and the mere increasing of tariff barriers does nothing to enhance this marginal product. Despite the high level of American wages, Americans export every year large quantities of farm products, minerals, and manufactured goods which compete successfully with similar goods produced by foreign labor which works for lower wages. The very fact of export proves that American costs

are no higher than foreign costs. The American employer can pay higher wages than his English, German, or Japanese competitor, and yet successfully compete with these competitors, because the daily production of the American workingman exceeds that of his English, German, or Japanese rival, in some fields exceeds it by a percentage greater than that by which American wages exceed foreign wages.

Professor Taussig has presented some striking facts illustrative of the superior effectiveness of American labor.<sup>3</sup> In 1918 the daily output of coal per underground worker was 4.68 tons in the United States, 1.19 tons in Great Britain, 1.4 tons in Prussia, and .91 of a ton in France. In 1905 the output of bricks per person employed was 141,000 in the United States and 40,000 in Germany. The United States production of pig iron per worker was 84.5 tons in 1909, as compared to only 39 tons per worker for Great Britain in 1907. For finished steel products the difference was even greater: 77 tons per head for the United States as against 25 tons for Great Britain. For tin plate the respective outputs per head were 100.4 tons for the United States and 25.6 tons for Great Britain. A report published by the United States Tariff Commission in 1921 revealed that the output of cotton yarn per spinner was 104 pounds a day in Japan and 414 pounds a day in the United States, and that the daily output per Japanese weaver was 145 yards of cloth as against 450 yards for the American weaver working on plain looms, and 1100 yards for the American weaver working on automatic looms.<sup>4</sup>

The only way in which foreign labor can compete with this superior productivity of American labor is by accepting lower wages. If American labor received the same wage as the less productive British, German, or Japanese labor, American goods would be much

<sup>3</sup> *International Trade*, Ch. XV.

<sup>4</sup> The international comparability of the figures is somewhat impaired by the fact that they refer to average rather than to marginal productivity. The product is the product of labor, capital, and natural resources. Where the higher American labor productivity is due to the use of more capital and natural resources per worker than abroad, interest and rent charges per unit of product will be greater than abroad, unless capital and natural resources are so much cheaper here that their low prices offset the greater quantities used. Nevertheless, in a rough sort of way these figures are indicative of the true superior productivity of American labor.



## 278 International Trade and Commercial Policy

cheaper in price than the products of the latter three groups. The higher American wage is, in brief, the manifestation and measure of the superior productivity of the American worker.

It is true, however, that once an industry which possesses no comparative advantage is established behind a tariff barrier in a country of high wages, high wages *in that industry* can be maintained only by a continuation of the tariff. Historically, the existence of industries dependent on protection, which it was hoped would eventually be able to stand on their own feet without protection, was the basis of the wages argument for protection. But, since the United States had one of the highest wage levels in the world long before she had any protective tariff, it is absurd to say that the tariff has caused high wages. When protection gives birth to a new industry, the new industry must pay the going rate of wages, i.e., the rate set by the productivity of labor in established and unprotected industries, in order to enlist the necessary labor services. *Once established*, these new industries can continue to pay these wages only by the grace of protection. For, without protection, these industries could not have paid wages high enough to attract a labor force, and would consequently not have been begotten. Herein lies the modicum of truth in the argument. As long as workers remain in those industries, their high wages are dependent upon protection.

Although protection can guarantee the payment of the going rate of money wages in the protected industries, it cannot guarantee the maintenance of real wages. Protection will cause real wages to decline—in the unprotected industries as well as in the protected industries. While money wages are maintained in the protected industries, the prices of the protected goods rise, and the fixed money wages buy fewer goods. This is the inevitable consequence of the diversion—through protection—of productive agents from industries in which the nation has a comparative advantage into fields where their productive efforts are less fruitful; the national income is lowered, and there is less to divide among the whole population.

The removal of the protective duties would not mean that the workers in the protected industries would be compelled to accept lower wages. The abandonment of the protected industries would simply force the released workers into other industries—industries

able to stand on their own feet without public subsidization. These might be either export industries or domestic industries. The increase in imports resulting from the abandonment of protection would foster an equivalent increase in exports, and the lower prices paid for the imports would release domestic purchasing power which would now be available for spending on additional imports or on more domestic goods.

The process of transition would admittedly be a difficult one, one which would meet head on the problem of vested interests. While dependence on protection is often exaggerated, any sudden withdrawal of protection would nevertheless probably create hardships in the form of depression and unemployment. Wherever it is decided to remove the shield of tariff duties, it should be done slowly and cautiously, so that as capital equipment wears out entrepreneurs will be discouraged from replacing it, yet no ruthless abandonment of capital will be necessitated. A dismissal wage to labor, to be paid from the public treasury, may be justified in order to remove from the shoulders of the workingmen the burdens of temporary unemployment while they are relocating.

These troublesome problems of transition are the strongest possible argument for the exercise of great caution in ever granting protection to an industry, for it is generally impossible to determine beforehand whether a particular industry is adapted to a given country. Unfortunately, once a nation embarks upon a policy of protection, political expediency makes it impossible to mark out certain industries for tariff favors and to deny such favors to others. To protect the textile manufacturer of Massachusetts, but not the sugar planter of Louisiana, looks like rank favoritism. American tariff legislation since the Civil War is one long story of political log-rolling. Any American willing to risk capital in a new industry has encountered little opposition in securing tariff protection for that industry.

The setting of legal minimum standards of wages and working conditions that raise labor costs in certain industries may force a difficult choice upon a country which enjoys relatively high living standards. Unless protection from cheap imports is granted, the industries adversely affected by the social legislation may be unable to compete with foreign rivals whose standards are less exacting.

## 280 International Trade and Commercial Policy

Success in improving the lot of workers by imposing minimum standards of wages and working conditions without increasing the costs of protection or precipitating unemployment in the industries affected thus rests essentially upon the success of domestic regulation of this sort in stimulating efficiency in production. Higher wages which are counterbalanced by increased productivity will not result in higher costs. No difficulty would be faced, of course, if simultaneously similar standards were imposed upon competing industries by other countries. One of the chief tasks of the International Labor Office has been to attempt to bring about a higher international level of labor standards by international convention, so that no nation may acquire competitive advantages by maintaining long hours and bad working conditions while other nations are attempting to eliminate these evils.

Powerfully entrenched labor unions may occasionally succeed in forcing employers to pay wages in excess of the value of the marginal product of their labor, at the existing prices and level of employment, if the industry which employs the unionized workers operates behind a tariff wall. Where unions do force wages above the value of the marginal product of labor at existing prices, entrepreneurs can avoid losses, and can continue to operate, only by raising the prices of their products.<sup>5</sup> Unless these enterprises are protected by a tariff, however, they will be unable to compete with the products of foreign enterprises. If the domestic industry had to sell in competition with the foreign industry, as it was able to do at the former level of wages, it could not meet the demands of its workers for higher wages. But such an increase in money wages would inure only to the benefit of the privileged group; other members of the community would be injured by it. Increased wages which depend upon increased prices injure all consumers, except those fortunate enough to share in the wage increase. And wages in excess of the competitive rate can be secured by a particular group of workers only by restricting the entry of other workers into the given occupation; all other workers are injured by such restrictions because the numbers of workers in other occupations are increased and their wages are consequently depressed. The increase

<sup>5</sup> Entrepreneurs will tend to adjust their employment of labor to the point at which the wage equals the value of the marginal product.

in the price of the product will restrict sales of the product and will therefore force some employees out of the privileged group into more crowded occupations. Free trade is thus an effective defense against the extortions not only of national industrial monopolies but of labor monopolies as well.

#### THE INDUSTRIALIZATION OF LOW-WAGE COUNTRIES

In recent decades, those who advocate protection in defense of the American wage level and the American standard of living have been able to win adherents to their cause as a result of the spread of industrialization to low-wage countries, particularly Japan. These protectionists sometimes admit that the American level of wages would ordinarily be in no danger from the competition of Oriental labor because the output of the American workingman is so much greater than that of the Oriental. But the situation may be drastically altered, they maintain, where the superior American effectiveness is due to the use of modern machinery and techniques. By adopting such machinery and productive techniques, the "pauper" labor of the Orient may overnight acquire every advantage which American labor possesses.

The more automatic machinery becomes, the more readily can it be transplanted; for the greater is the responsibility carried by the machine, and the less is the skill demanded of the operator. With imported automatic machinery, foreign labor that receives only a small fraction of the American wage can produce competing goods at a cost much lower than the American cost. More than that, the machinery itself may be copied and reproduced more cheaply in these countries than in the United States, so that American producers will have to face the double handicap of competing with cheap labor working with cheap machinery. Both the Germans and the Japanese have been accused of being arch plagiarists. The disastrous results of such industrial transplantation are all too effectively depicted, for these alarmists, in the Bata shoe factories in Czechoslovakia and the cotton textile industry in Japan. Japanese, Chinese, and Indian cotton cloths have not only swept western cloths from the Far East, except in India where the British have been able to limit imports of Japanese goods by means of an import quota, but have even invaded the American domestic market. Will

## 282 International Trade and Commercial Policy

not these countries deluge us with the products of cheap factory labor, once they have equipped themselves with the latest machinery? And is not the only means of protecting our high wage level a high tariff wall?

It is easy to exaggerate the danger. The transplanting of an improved system of production carries with it certain encumbrances, encumbrances which have been clearly described by Professor Taussig.

However automatic a machine may be, intelligence and knack in operating it are always called for; though less, perhaps, among the ordinary hands than among the machine tenders and foremen. It is a common experience that the same machinery will produce in the country of its invention better results than when transplanted. Those very automatic looms, just referred to, are making their way very slowly into Europe. They do not fit into the traditional industrial practices, and do not accomplish what they accomplish in the United States. . . . We hear frequently of the menace of the cheap labor of China, India, Japan. . . . The truth is that they will in all probability never thus equip themselves (with the latest machinery). To do so, would require more than the mere shipment of the machinery and the directions for working it. A completely different industrial environment would need to be transplanted.<sup>6</sup>

It is not to be denied, however, that some of the industries developed in the western countries will prove themselves adaptable to productive conditions elsewhere. The recent keen competition from the Japanese cotton textile industry is a case in point. The only way to prevent the expansion of such industries into other regions would be to embargo exports of machinery. But the shutting-off of export markets would place such hardships on machine manufacturers that drastic action of this sort would prove politically unfeasible; economically, an embargo on exports of machinery might easily cause the domestic costs of producing machines to rise. Furthermore, while it might be possible to prohibit exports of machines, it would be well-nigh impossible to prevent the export of machine plans and specifications. Samuel Slater, a former English cotton-mill worker, migrated to Rhode Island and succeeded in 1790 in constructing from memory two carding machines and a

<sup>6</sup> F. W. Taussig, *Some Aspects of the Tariff Question*, Harvard University Press, 1931 ed., p. 45.

water frame with twenty-four spindles, despite an English embargo on exports of machines and plans. Even military secrets "leak out" and are adopted by rival nations.

The rapid growth in Japan of large-scale industries such as cotton and rayon textiles is not to be accounted for entirely by the application of cheap labor to modern machinery that has been copied from other nations. The factor most immediately responsible for the unprecedented expansion of Japanese exports of the 1930's was her abandonment of the gold standard in 1931 and the subsequent depreciation of the yen in the foreign exchange market. The best method of meeting threats to a nation's export and domestic industries caused by deliberate currency depreciation by other nations is not the erection of tariff barriers, which can only lead to retaliation and an inexorable strangulation of world trade, with resultant depression of world living standards. Neither is it competitive currency depreciation, for the consequences of competitive currency depreciation are fully as deplorable as the raising of tariff barriers. Salvation lies rather in international monetary agreements similar to the Tri-Partite Agreement of 1936, signed by the United States, England, and France, according to which no one of the parties to the agreement was to devalue its currency without the approval of the other parties, and then only when it was agreed that devaluation was necessary in order to bring the nation's price and production structure into equilibrium with the world system. The postwar counterpart of the Tri-Partite Agreement is the Bretton Woods agreement for an International Monetary Fund.

Another factor facilitating the invasion of export markets by Japanese cotton textiles has been the stagnation of this industry in England and the United States. The failure to set aside adequate depreciation reserves and to scrap obsolete equipment, financial manipulation, and incompetent management have made the British and American industries vulnerable to efficient competition from abroad. It has been reported that 60 per cent of the American cotton mills are definitely obsolete and that only 10 per cent are modern, up-to-date plants. The migration of the American industry from the northern to the southern states has been encouraged, in part, by the failure of northern management to maintain productive efficiency. In contrast, the Japanese have in recent years made great efforts to

## 284 International Trade and Commercial Policy

develop machinery and improve industrial organization, with the result that machinery of high efficiency has been developed which is setting the pace for other nations.

Despite all this, it must be realized that a particular industry developed in a certain country may later prove to be definitely better adapted to some other country. This represents a shift in the geographical location of the comparative advantage of that particular industry. If the country of adoption also succeeds in improving the technique of the industry, an added point of advantage is acquired by the country of adoption. And if, in addition, the adopted country enjoys a lower level of wages, entrepreneurs in that industry in the country of its original development will find the foreign supply price lower than their own.

Will this result in a lowering of the standard of living in the country where the industry originally developed? No. The adjustment which this competition compels will not cause any loss of national income so long as the industry feeling the foreign competition is not one which produces chiefly for the export market; it will, however, force an alteration in the distribution of that income. The lowered price will force some, but not all, of the productive factors in that industry to accept smaller rewards. The factors which are forced to accept lower rewards will be those which are specific to that industry, i.e., land and capital instruments which cannot be transferred to any other industry. The industry will continue to operate, even though the rewards of these factors fall, and fall even to zero, as long as circulating capital continues to reproduce itself and to earn the going rate of interest. Producers lose, to be sure, through being forced to mark down the value of their capital equipment; but their loss is balanced by an equal money gain to consumers, realized in the lower price of the commodity. The national income is not diminished.

But what if the price sinks so low that interest on circulating capital is not earned, or fixed capital has to be replaced? In that case the industry will have to shut down, for it will no longer be able to pay the prices necessary to hold its non-specific factors, chiefly labor and circulating capital. This implies, however, that these factors have alternative employments where they may earn their market price. So the closing of the industry represents no loss

in income to the community. In fact, the contrary is true. Any attempt to retain the factors in this employment by means of a tariff would forcibly retain them in an employment of less productivity than others which are available to them.<sup>7</sup> These alternative employments will likely be found in the export industries, since the increase in imports, occasioned by this shift in comparative advantage, will place in the hands of foreigners the foreign exchange necessary to increase their purchases abroad. Domestic industries, too, will expand because domestic consumers will find their purchasing power increased as a result of the lowered price of the article now imported, and they will consequently increase their purchases of domestic goods.

The outcome is less happy where the new competition occurs in an export industry. As factors are forced out of the industry, the compensating gain enjoyed by consumers will be relatively small since only a portion of the output of the industry is consumed at home. Either the factors in this industry suffer a diminution of their rewards, or the non-specific factors are pushed into other employments where they must cause some reduction in marginal productivity. If non-specific factors are unwilling to accept any reduction in their rewards, unemployment will result. But a tariff will not help, because the market lost is not a domestic market but an export market; and tariffs are impotent to protect a home industry in an export market. One compensating factor may appear, however. As the competing country expands its production, its purchasing power in foreign markets increases, and some of this purchasing power may be spent for other products of the nation in question.

There is one circumstance under which a tariff may be justified. If a particular industry is being undersold by foreign producers because labor abroad is receiving less than its true marginal product, and if this exploitation appears to be only temporary, it may be wise to protect the domestic industry from a temporary disturbance which can bring no lasting benefit to the nation. For the attainment by foreign labor of its full marginal product at some later date will wipe out any advantage which foreign producers have over domestic producers and will cause the foreign cost to

<sup>7</sup> For a more complete discussion of this topic see von Haberler, *The Theory of International Trade*, pp. 182-189.



## 286 International Trade and Commercial Policy

rise. It is doubtful whether the temporary gains to domestic consumers will be sufficient to offset the costs of disrupting the domestic industry. This very condition of labor exploitation probably exists today in Japan, where there is an overabundance of population. Most of the factory workers are recruited from the agricultural population, the class which furnishes the bulk of the increase in population. Since there are large supplies of potential workers on the farms ready to shift to the factories, wages in the factories are influenced largely by the incomes of Japanese farmers, even though these factory wages are considerably less than the productivity of labor in the factories. The feasibility of erecting a tariff barrier against the products of this labor may, however, be open to question; for the present trend of population growth in Japan shows little promise of slowing down markedly, so that this exploitation, instead of being only temporary, may be expected to go on indefinitely. Factory workers in Japan, in other words, constitute a lowly-paid, non-competing group, which gives Japan a comparative advantage in the production of many products and makes these products available to the outside world on the most favorable terms.

It must be remembered that a nation will tend to specialize in producing goods which require large use of those factors which she possesses in abundance, and will import goods making large use of those factors which are scarce within her borders. Low-wage countries like Japan should increasingly dominate those industries using large amounts of cheap labor, while a country like the United States should continue to maintain an advantage in industries which make large use of certain natural resources, capital, and highly skilled and technical labor and are characterized by rapid technological advance. In general, raw materials and fabricated goods in which the labor element is small are expensive in Japan, as compared with similar goods in the United States. It is clearly to the advantage of the United States to exchange for Oriental goods or services containing much labor American products in which the labor element is not large. As one writer has expressed it, "The abundant labor of the Orient is too much of a genuine bargain to overlook."<sup>8</sup>

<sup>8</sup> See Vernon A. Mund, "The Trade Problem of the Pacific," *American Economic Review, Supplement*, March, 1937, pp. 43-48.

## A TARIFF TO KEEP MONEY AT HOME

The persistence of the crudest mercantilistic ideas is seen in the argument which advocates a tariff to shut out imports so that money will not be drained abroad. In the domestic sphere, the recrudescence of this fear of a community's losing money is found in the policy of some municipal officers in refusing to permit circuses to exhibit in the town "because they carry off so much money." Expression is given to the same fallacy in respect to international trade in a familiar statement incorrectly attributed to Abraham Lincoln: "I do not know much about the tariff, but I know this much, when we buy manufactured goods abroad, we get the goods and the foreigner gets the money. When we buy the manufactured goods at home, we get both the goods and the money."<sup>9</sup>

Only the wide circulation of the argument warrants giving any space to it, for it has no merits. As Beveridge has so aptly remarked, "the only sensible words in it are the first eight words."<sup>10</sup> This argument represents an unmitigated misunderstanding of international trade. Its chief error lies in the assumption that imports are paid for by sending out money, that importation results in the loss of money; it assumes, on the other hand, that the diminution of imports will result in the accumulation of money. It has been shown in preceding chapters that a country's imports are paid for by her exports of goods and her rendering of services to other nations, that money (gold) moves only to adjust temporary disturbances in the international balance of payments. True, a change in the volume of imports or exports may stimulate an *initial* movement of gold. But under ordinary conditions of peaceful trade the movements of gold will be small in comparison with total international transactions, and temporary. Certainly it is not true that gold flows in payment for each item of import or export, or that a reduction of imports will bring a continuing inflow of gold. The reduction in imports will simply cause exports to contract by an equal amount.

Even more grossly fallacious is the implication that a nation

<sup>9</sup> For a discussion of the origins of the statement see F. W. Taussig, *Free Trade, the Tariff and Reciprocity*, pp. 34-47.

<sup>10</sup> Sir William Beveridge, *Tariffs: The Case Examined*, Longmans, Green & Co., Inc., p. 28.

## 288 International Trade and Commercial Policy

grows wealthy by increasing its stock of money, that, in other words, wealth and money are synonymous. Real wealth consists of the necessities and luxuries of consumption and of the instruments of production: food, clothing, houses, movies, concerts, automobiles, machinery, factories, etc. Money is merely a medium of exchange, a measure or symbol of wealth. A gold-mining country like South Africa is less inclined to confuse gold and wealth than are nations which mine no gold; for the very lifeblood of the gold-mining country depends upon the exportation of gold and the acquisition of much wanted commodities from abroad. To her, gold is merely a means to an end; the end, the actual articles of consumption. In the parlous days of 1940, when world conditions had caused nearly three-quarters of the world's monetary gold—twenty-two billions of dollars worth—to be sent into the haven of the United States, even American arch-protectionists began to question the desirability of possessing so much gold and to wonder what it would avail them if gold were demonetized by the rest of the world. The evils of inflation were beginning to be feared, and the "benefits" of a large stock of gold doubted.

The long and short of it is that wealth consists of an abundance of goods and services, not of an abundance of money. Trade increases the plentifulness of goods and services. Tariffs will not cause a continuous inflow of gold, even if that is desired, but they will reduce the volume of world trade and through the strangulation of trade will prevent the maximum production of goods and services which world resources make possible.

### TO EQUALIZE THE COSTS OF PRODUCTION

The United States Tariff Acts of 1922 and 1930 adopted a principle which was hailed as the "true" principle of protection. This principle maintains that tariff rates should not be prohibitive but should be only high enough to offset the lower costs of foreign producers; they should merely equal the differences in costs of production between American and foreign producers. To accomplish this objective, these acts gave the President the power to raise or lower the duties laid down in the acts by as much as 50 per cent; within this limit, he was directed to change import duties by amounts

which would make the foreign costs plus the tariff equal to domestic costs.

This doctrine has an engaging appearance of fairness. "It seems to say, no favors, no undue rates. Offset the higher expenses of the American producer, put him in a position to meet the foreign competitor without being under a disadvantage, and then let the best man win. Conditions being thus equalized, the competition will become a fair one. Protected producers will get only the profit to which they are reasonably entitled, and the domestic consumers are secured against prices which are unreasonable."<sup>11</sup>

This principle has been called the "scientific" principle of tariff-making. One thing can be said in its favor. If a country *must* levy tariff duties, they should certainly not *exceed* the differences between domestic and foreign costs. If they do, an invitation is given to domestic monopolies to take over the protected domestic industries and to raise prices to domestic consumers as far above foreign prices as the tariff permits.

But as a scientific principle for the justification of a tariff it is rank nonsense. The extension of the principle to its logical conclusion would mean the utter annihilation of international trade. For it must be remembered that the very basis of international trade is that supply prices for certain goods are lower in foreign countries than at home. Add to the foreign supply price a tax exactly equal to the differences in costs and every inducement to purchase foreign products disappears.<sup>12</sup> No basis for international trade remains; and with the cessation of trade, international specialization ceases.

The protectionist may answer in rebuttal that duties are not to be pushed so high that all imports will cease; many products will continue to be imported. But where draw the line? The principle furnishes no guide. Applied unswervingly, it means that the domestic production of every article is to be enabled to hold its own. The

<sup>11</sup> From F. W. Taussig, *Free Trade, the Tariff and Reciprocity*, p. 134. By permission of The Macmillan Company, publishers.

<sup>12</sup> Actually, a trickle of imports would probably continue in any case. Some goods would flow in because of the impossibility of producing them within the country, e.g., products of different climates, and certain minerals not found within the confines of the nation; others would be imported because of the prestige of imported goods.

## 290 International Trade and Commercial Policy

greater the cost of any domestic product, compared with a similar foreign product, the higher will be the duty levied on that product. One arch-protectionist has declared that he would vote for a duty of three hundred per cent, if that were necessary to equalize the costs of American and foreign producers. Logically, he could vote for a duty of five hundred, or one thousand, per cent as readily as for one of three hundred per cent. In fact, if an advocate of the principle fails to support a duty of one thousand per cent, when such a high duty is necessary to equalize foreign and domestic costs, he can support protective duties only on some different ground.

Even if these fundamental theoretical objections did not exist, such grave pitfalls face the practical application of the equalization-of-costs principle that its adoption would seem to be impractical. Whose cost of production shall be equalized? The monetary costs of different producers in any industry show great variation in every country. Some producers have low costs and enjoy high profits, while others have high costs, and may even be operating at a loss. Should high-cost producers be protected, at an extortionate cost to consumers, or should only average, or bulk-line, costs be considered? And what foreign costs are to be taken as a basis of comparison? Costs vary from country to country, and they vary within each country. Furthermore, the difficulties of determining the costs of any particular establishment are great, especially those of an establishment abroad. Attempts to determine them may cause ill will. Producers are not eager to reveal to foreign investigators, or to domestic investigators for that matter, the secrets of their business files, especially when such revelations may cause them to face higher foreign tariffs.

A special form of the argument sprang up in Great Britain after the first World War, as a consequence of the heavy burden of taxation imposed on the British people. It was argued that, since the state was responsible for the additional handicap of taxation forced upon British industry, it was only just that the state impose a tariff on imported goods equivalent to the difference between British and foreign taxes. It was unfair, so the argument ran, to require British manufacturers to compete with manufacturers in countries where taxation was less burdensome.

Certain fallacies of this proposition are obvious. Some taxes do not enter into production costs. This is true of income taxes, inheritance taxes, and generally of profits taxes, which are paid out of, and rest upon, final income. Even though taxes on production—excise taxes, duties on imported or semi-finished materials, turnover taxes—do rest more heavily on all industry than similar taxes in foreign countries, the position of domestic producers cannot be improved, either in export or domestic markets, by equalizing duties on imports. The truth of this statement is obvious so far as foreign markets are concerned. Insofar as domestic producers suffer higher costs as a result of taxes, their handicap in competing with foreign producers in neutral markets is not removed by levying import duties on goods imported into the domestic market; such duties will not lower their own costs, nor will they handicap foreign competitors.

The statement is equally true, if less obvious, with respect to competition in the home market. The economic welfare of the nation will not be raised by the imposition of import duties, even though home producers are handicapped by internal taxes. The imposition of general production taxes will, it must be admitted, raise the general level of domestic costs and prices; and this will make it more difficult to meet foreign competition. But, in the long run, goods will be imported only to pay for the goods and services sold abroad. The imposition of import duties will reduce the entry of foreign goods; but it will also reduce the export of domestic goods. Furthermore, the cessation of imports will force a redistribution of productive resources among industries and will cause the transfer of factors from employments of greater productivity to those of less productivity. If trade is unimpeded by tariffs, the additional burden of taxation will not destroy international trade. Although all costs and prices will rise, the comparative scale of costs will not be altered nor will the character of trade be changed. Industries best suited to this country will settle here; those best suited to other countries will locate there. The only effect of the general tax will be to diminish somewhat the volume of international trade and the amount of specialization.<sup>13</sup>

<sup>13</sup> Where a tax is levied in such a way as to affect the costs of different industries differently, the relative cost positions of industries within the country are altered and the currents of international trade affected.

## 292 International Trade and Commercial Policy

When the tax is not general but applies only to one particular line of production, the case is different. In this case a tariff is justified. The especial suitability of a given line of production for taxation does not impair the advantages of specializing in that field of production. The failure to offset the internal tax by an export duty might bring such specialization to an end, and incidentally dry up the source of tax revenue.

### A TARIFF TO CONSERVE NATURAL RESOURCES

Protection has been advocated as a means of preventing an undue extension of specialization in industries exploiting irreplaceable natural resources. Where a nation possesses certain rich natural resources, it is to be expected that she will develop a comparative advantage in industries based upon these resources. Yet it may happen that a too rapid and wasteful development of these resources will lead to the sale of their products to foreign countries at prices which later may appear to have been outrageously low. In short, from a longer viewpoint it may be wiser to restrict the development of these natural stores of materials now, so that a higher price for them may be realized in the future. It is probable that such an "uneconomic" utilization is at present being made of the limited stores of petroleum in the United States, and some would even survey with concern the rapid reduction of our stores of copper, iron ore, and coal.

The most direct way of reducing exports of materials whose supplies it is desired to conserve would be to levy duties upon their export. But, since export duties in the United States are unconstitutional, it is argued that the same end may be attained by levying duties against imports, because smaller imports will necessitate smaller exports. The difficulty with this remedy is, however, that there can be no assurance that exports of any *particular* product will be diminished even though the total of *all* exports declines. If the raw materials whose conservation is sought are materials in the production of which the nation has an outstanding superiority over other nations, it is likely that the reduction in exports will take place chiefly in other directions. The possibility that a protectionist policy will lend effective support to conservation is, therefore, slight.

If conservation is deemed desirable, more direct and effective

means than protection are available for accomplishing it, e.g., the direct control of output. There is always the possibility, of course, that any conservation policy may overreach itself by conserving things which later may become comparatively valueless, either because other and better ways of producing the conserved materials are discovered, or because superior substitutes are found. Furthermore, the argument for conservation carries less force where it applies to replaceable resources, like timber, as long as the price of the virgin product is high enough to meet the costs of reproducing it. But considerations of flood control and soil erosion may make the cutting of timber unwise, although considerations of supply alone would warrant cutting.

#### A TARIFF TO IMPROVE THE TERMS OF TRADE

A protectionist argument deserving of more serious consideration than any thus far presented, but one which has never gained popular support, is that which advocates the levying of import duties in order to advance the economic well-being of the people by bettering the international terms of trade. The imposition of protective duties will curb imports; but, since exports will not immediately be reduced, the deficit in the balance of international payments will be met by the importation of gold. The international gold movement will result, however, in a rise in prices, costs, and money incomes in the tax-imposing country, and a fall in prices, costs, and money incomes in the countries losing gold. The prices of goods upon which no duties are levied and which continue to be imported by the duty-levying country will fall, while the prices of exported goods will rise. For each unit of exports, then, the tax-imposing nation receives a greater quantity of imports than before. Imports are obtained at a smaller cost—the international terms of trade have been altered in favor of the country levying the duties, and as a direct result of the duties.

There is no gainsaying the benefits that flow from the improved terms of trade. Yet something more happens: a real offset to the gain from the improved terms of trade appears. If the duties are protective, the rise in the prices of the taxed goods will foster the domestic production of these goods. Consumers will have to pay a higher price for the taxed goods, and this higher price represents



## 294 International Trade and Commercial Policy

a national loss. Imported goods are cheaper, but protected goods become more expensive. There is a balancing of loss against gain. The loss is obvious and appears in the higher prices of the goods whose domestic production is stimulated by the duty. The gain is less obvious; it appears in the more favorable barter terms of trade. It is impossible to state whether the loss or the gain is the greater, whether on balance there is a net gain or a net loss.

But an improvement in the terms of trade can be misleading as an index of national gain in yet another respect. The advantage which a nation derives from its foreign commerce depends as much upon the *extent* of that commerce as upon the *terms* upon which it is conducted. A country's gain from international trade can be seriously diminished by a sharp reduction in the volume of trade, even though the *terms* of trade are altered in that country's favor. And, although duties may improve the terms upon which a country's trade is conducted, they surely reduce the extent of its trade. A nation may lose more from the reduction in its foreign trade than it gains from an improvement in the terms of trade.

There is no question here of unusual returns being received by capital and labor in the protected industries, because under competition returns cannot be larger than in other industries, allowing for the differences in risks. In fact, labor and capital in these industries can be assured of returns even as great as those received in unprotected industries only by the grace of continued protection.

Any possibility that protection will produce even the questionable gains from more favorable terms of trade rests, moreover, upon the protection being only partial. If all imports are shut out, there will obviously be no terms of trade whatever. There will be no trade! But there are additional grounds for questioning whether any gain, if it is realized, will persist. If one country can improve its international trading position by imposing a tariff, other countries can play the same game. And the levying of duties on imports by all the countries concerned will increase the loss arising directly from the protective duties, further narrow the range of trade, and lessen the total gain from the international division of labor. The possibility of any nation's improving its terms of trade will become infinitesimal; but the loss from protection will be certain.

## THE INFANT-INDUSTRY ARGUMENT

Unlike most of the protectionist arguments considered in the preceding sections of this chapter, the argument for the protection of young industries is not rooted in theoretical fallacies. It is based upon the presumption that the superior efficiency which one nation has over another in a particular line of production arises solely from having an earlier start. Once the industry is fully developed in its new national habitat, it may prove to be as efficient, or more so, as in the country of its origin and may be able to compete successfully with the established industry abroad. Exposed to the full competition of a mature industry abroad, however, the industry may never develop in this favorable domestic environment without artificial stimulation. In the beginning, an unfamiliar undertaking in a new country must in most cases be on a small scale, must depend upon labor untrained for it, and must face all the risks inherent in leadership inexperienced in it. A stimulus to the assumption of the heavy risks incident to the founding of a new domestic industry, in the form of a protective tariff, may therefore be in order; for, once the industry has got a start, it may be able to secure for itself economies which will enable it to produce at costs below those prevailing abroad, plus costs of transportation. It is frankly admitted that the nation will have to sustain a temporary loss in the form of a higher price for the product during the period of development; but this loss will be more than compensated by lower prices, it is alleged, once the industry reaches maturity and is able to undersell the foreign industry.

This argument was first formulated by Alexander Hamilton in his famous Report on Manufactures presented to the United States Congress in 1791. Hamilton saw the United States as a group of states still loosely bound together politically, whose economic activities were chiefly agricultural. He perceived in protection a device which might make his nation economically less dependent upon foreign nations, which might bind the states more closely together, and which promised to make non-human energy a more important factor in manufacturing pursuits. From the United States the doctrine was carried to Germany in the nineteenth century by Friedrich List. Germany, though an old country, was, like the United

## 296 International Trade and Commercial Policy

States, young industrially. Her population was to a considerable extent engaged in agriculture, and what industries she did possess were far from modern in technique and equipment. Industries in both countries had to face the competition of the modern and efficient industries of Great Britain. To List, the development of the productive powers of a nation was of much greater importance than present cheapness, and he felt that it might well be worth while to incur a temporary loss in order to secure a more than proportionate future gain.<sup>14</sup> In both countries there was force to the contention that conditions were most favorable for the use of power and machinery and for large-scale production, and that the transition could be made more easily and the beneficial results realized sooner by placing a temporary handicap upon competitors abroad.

Despite the theoretical soundness of the principle, situations in which infant-industry protection may be adopted are not numerous. And the actual application of protection to young industries, along the lines advocated by Hamilton and List, encounters such difficulties and involves such dangers that few students of the tariff would dare recommend a tariff on infant-industry grounds. It hardly ever applies to the protection of agriculture, because agriculture is unusually susceptible to increasing costs as production is expanded and is chronologically a primary industry in every country, so that at any given time it is as fully developed technically as general conditions allow. Moreover, even its arch-supporter, List, did not favor protection for a country which had attained a high state of industrialization and had acquired great wealth and power, for then the nation is in the van of industrialization and is able to take care of itself. The economic and technical environment favorable to the development of any new industry is already provided, and, if a particular new industry fails to appear, there is a strong presumption that it is unadaptable to the country. Protection for young industries is, then, a policy only for nations which are just emerging from the agricultural stage and which are yet a long way from industrial maturity.

But even for such nations, the infant-industries argument is an

<sup>14</sup> List's doctrines are formulated in his book *Das nationale System der politischen Ökonomie*.

argument not for the general protection of manufacturing industries but rather for the protection of selected industries. In order to justify protection, an industry must give strong promise that after the removal of the duty, following a period of trial, the industry will be able to stand on its own feet. If protection is going to be really worth while, and if the temporary cost of protection is later going to be compensated, the home industry must eventually be able to produce at a money cost per unit of output lower than the price at which the article could be imported. Furthermore, protection must be temporary. Duties must be removed when the industry has grown strong, or when it has failed to prove itself within a reasonable period. List proposed thirty years as the maximum limit of governmental favor; if the protected industry was then unable to stand on its own feet, protection had failed. Finally, the duties should be moderate; List suggested that they should not exceed 25 per cent ad valorem. Too high duties will only encourage industries not adaptable to the country, and, hence, industries not likely to succeed.

Although many economists would admit the validity of the infant-industry argument in principle, under the conditions so carefully set down by List, it is doubtful if any economist at all conversant with tariff problems would care to grant protective duties to any specific industry on the grounds that within a reasonable period that industry would attain a robust, independent adulthood. How can one prophesy whether any particular industry is suited to a young and developing country? Some industries may be worthy of governmental encouragement on this ground; others certainly are not. But what man, or group of men, has the prescience, before a given industry has even sprouted in the country, to foretell that that industry is so well suited to the country that once it is well started, it will be able to produce at costs below those of its foreign competitors? And if a correct answer to this question cannot be foretold, which it rarely can, on what rational grounds is the government to refuse infant-industry protection to any optimistic and importunate group? Even after an exhaustive investigation into the histories of several leading American industries which had enjoyed protection for a long period of years, Professor Taussig found it impossible to determine conclusively how far infant-industry protection had been

## 298 International Trade and Commercial Policy

successful in this country. Some of these industries appeared to be still dependent on tariff support; others gave promise of attaining a sufficient degree of efficiency to enable them to stand on their own feet without protection. But the true competitive status of each industry was veiled by the continuance of protection. Professor Taussig's study indicates only too well the practical difficulties involved in the application of infant-industry protection.<sup>15</sup>

The greatest danger in granting protection to young industries is that once an industry secures protection, it never willingly renounces it. Duties which were originally intended to be in effect for only a few years, while the industry was supposed to develop to the stage where it could successfully meet foreign competition, invariably become permanent. The time for the removal of the duties never seems to arrive. The infants always remain babes in arms, regardless of how big and powerful they become! The bigger and stronger they become, the more they devote their manly strength to fighting for bigger and more permanent protection. This is the lesson of the tariff history of the past seventy-five years in every country which has adopted protection. The impossibility of determining in advance what industries are suitable for encouragement assures that many unsuited ones actually receive it. And very high duties induce an excessive expansion of other industries and call into existence high-cost establishments. Obviously, neither the industries unsuited for the country nor the high-cost establishments can carry on without protection, and both will fight bitterly against its withdrawal. These economic weaklings become powerfully entrenched vested interests who argue that the removal of the tariff will create unemployment; thus they win public support. Furthermore, even those industries which could comfortably survive without protection join in the clamor for maintaining it, either because they wish to continue to enjoy the large profits which it permits, or because they want it as a shield against possible, keener future competition from abroad. The continuance of a tariff is unfortunately no proof that it is still necessary.

While it must be admitted that protection has on occasion been helpful in nurturing new industries, it is open to question whether protective duties are really necessary to stimulate the growth of

<sup>15</sup> See his *Some Aspects of the Tariff Question*.

manufactures suited to a particular country, whether private initiative will not eventually seek out any opportunity for profitable investment. In the United States the cotton, wool, and silk textile and the iron and steel industries have grown to maturity under high protection. But more recently the automobile, movie, and radio industries have attained huge size, and have even entered foreign markets, with no protection. And the existence of free trade within the continental United States has not interfered with the springing-up of new industries in the South and Midwest and on the Pacific coast in competition with the established industries of the North Atlantic states. A thriving cotton manufacture has grown up in the South in the face of the competition of the established industry in New England; a strong boot and shoe industry has developed in St. Louis, Chicago, and Milwaukee, despite a firmly entrenched industry in New England and New York State; and the iron and steel industry along the southern shores of the Great Lakes today rivals the much older industry of the Pittsburgh area. These examples could be multiplied. The point is that where the field has been favorable for the development of a new industry, whether because of rich natural resources, advantageous location, or the ingenuity of business leadership, the industry has spread and prospered, in the face of the competition of entrenched establishments in the older states. No artificial stimulation of enterprise and no protection against the manufactures of the Eastern states has been necessary.

In principle, the infant-industry policy of protection is little more than a modification of the policy of free trade. Protective duties are to be only temporary; their sole purpose is to enable domestic industries to develop to the stage where they can survive without the duties. The ultimate goal is free trade! Unfortunately, this ultimate goal is rarely attained. Alfred Marshall stated in his famous memorandum on fiscal policy in 1903, after a first-hand study of international trade in the United States, "a protective policy, in fact, is a very different thing from a protective policy as painted by sanguine economists, like Carey and his followers (American protectionists), who assumed that all other people would be as upright as they knew themselves to be, and as clear-sighted as they believed themselves to be."<sup>16</sup>

<sup>16</sup> Quoted by Beveridge, *Tariffs: The Case Examined*, p. 105.

## *Arguments for Protection* (Continued)

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### TO DIMINISH UNEMPLOYMENT

The widespread unemployment which characterized the depression of the nineteen-thirties brought forth, among other panaceas, demands for more and higher import duties. Imports, it was argued, represent the employment of foreigners at the expense of domestic workers; and, while the consumption of imported goods may be no cause for concern when there is no serious unemployment at home, their continued use cannot help but be a matter of the gravest concern when thousands, and even millions, of domestic workers are unable to find work. Imports can be excluded by the imposition of prohibitive import duties, and domestic consumers will then spend on home-produced goods the money which they have been spending on foreign goods, thus opening up vast new employment opportunities for domestic labor. Domestic demand will be forcibly shifted from foreign-produced to home-produced goods, and employment at home will be increased—albeit at the cost of employment abroad.

It must be granted that employment in any specific home industry can be increased by the levy of protective import duties, provided the demand for the protected article is not completely elastic. But the real question is not whether employment in any particular industry can be increased; it is rather whether *total* employment in the nation can thereby be expanded, whether the increase in employment in the protected industry may not be offset by a decline in employment in other industries. Most free-traders would deny that protection can reduce *total* unemployment; they would reply that the curtailment of imports will involve an equivalent curtailment of

exports and will therefore cause unemployment in the export industries. They would insist that no *net* reduction in unemployment will ensue.

Although this objection of the free-trader possesses a considerable degree of validity, it overlooks one situation in which a protective tariff may succeed in reducing unemployment. If the newly employed workers in the protected industries spend their entire incomes to purchase the products formerly exported or new imports, no unemployment will occur among workers in the export industries, and the new employment in the protected industries will constitute a net addition to the nation's employment.<sup>1</sup> There is little likelihood, however, that the entire incomes of the workers employed in the newly protected industries will be spent on goods formerly exported or new imports, even in a nation where a sizable proportion of the total goods consumed is imported, such as Great Britain. A part of the incomes of these workers will be spent on strictly domestic goods, and in a country as nearly self-sufficient as the United States this will be a large part of the total. But to the extent that these newly created incomes are not spent on goods formerly exported and new imports, the production of export goods will decline, due to the decline in imports, and this will generate unemployment in the export industries. The net gain in employment will therefore be limited by the size of the expenditures that the newly employed workers in the import-competing industries make on former exports and new imports; such expenditures will check at its source unemployment which might originate in the export industries.

The protectionist will insist, however, that the possibilities of reemployment from protection have thus far been understated. If unemployment in a nation is widespread, the expenditure of their new incomes by the reemployed workers in the protected employments will create employment in other domestic industries, which

<sup>1</sup> This assumes that the demand for the excluded imports is unity, i.e., that the same amount of money is spent on these goods when they are produced at home as was spent on the imported articles, regardless of the higher prices of the home-produced articles. This case is discussed more fully by Sir William Beveridge, *Tariffs: The Case Examined*, pp. 58-62. See also P. T. Ellsworth, *International Economics*, pp. 324-335. The present discussion is indebted to Ellsworth.



## 302 International Trade and Commercial Policy

will offset the reduction in employment in the export industries. It is conceivable, for instance, that the initial spending on the products of protected industries of two million dollars formerly spent on imports could eventually eliminate unemployment in a nation. If the newly hired workers in the protected industries spend their entire incomes on domestic products, there will result an additional two million dollars of employment. If these last employed, in turn, spend their new incomes on domestic goods, two million dollars more of employment will result. And, if there is no interference with this circuit of spending, unemployment will eventually disappear!

Unfortunately, two forces operate to curb any such Utopian development. In the first place, "leaks" in the stream of spending occur. The average worker will not spend or invest all his new income; he will save part of it, i.e., deposit it in an idle bank account. Another part may be used to repay old debts, and the creditors, in turn, may choose to hoard a portion of their receipts. The repayment of old debts owed to banks will cause bank deposits to diminish and will further reduce purchasing power. Moreover, the net addition to primary spending may well be less than two million dollars, the sum originally spent on protected goods, because government payments for unemployment relief are likely to be reduced as employment increases, and the unemployed may cease drawing upon their savings, something they have been forced to do while out of work. When consideration is given to these "leaks" in the initial and succeeding expenditures, which remove funds from circulation or shut off other flows of funds, it is realized that the prospects of reemployment are not nearly as rosy as they appeared to be at first glance. The increase in the national income and in employment that originates in the new expenditures for domestic goods will not be infinite; it will be limited to a certain finite multiple of the original expenditures. It has been estimated that the multiplier for the United States may be no more than two, i.e., the total expenditure on employment, primary and secondary, may be approximately twice the initial expenditure. Therefore, the original outlay of two million dollars on protected goods might be expected to provide no more than four million dollars of new employment.

The second factor limiting the reemployment of workers that

results from new expenditures generated by protection is the decline in exports which is begotten by the reduction in imports. Just as increased expenditures on protected goods will call forth primary and secondary *reemployment*, so reduced expenditures on exports will lead to primary and secondary *unemployment*. The multiplier works in both directions. As workers in the export industries are thrown out of jobs, they will curtail their own expenditures, and, as a result, other domestic workers will become unemployed. Thus, the reduced disbursements to labor for the production of goods for export will set in motion forces causing a contraction in employment, forces which resemble, but have effects contrary to, those generated by enlarged outlays for labor in the protected industries. If the two multipliers have the same value, the sequence of expenditure-decreases originating in the export industries will just cancel out the sequence of expenditure-increases arising in the protected industries. There will be no net addition to employment unless the tendency to expansion set in motion by reemployment is greater than the tendency to contraction set up by unemployment.

Any *net* addition to employment can occur, provided the positive and negative multipliers are of equal magnitude, only if a part of the new incomes of workers taken on by the protected industries is spent for export goods or for new imports. If wage-recipients in the protected industries spend on export goods \$200,000 of the \$2,000,000 initial outlay by consumers for protected goods, the decline in the production of export goods will be only \$1,800,000, instead of \$2,000,000, and total employment will increase by \$200,000. The multiplier will not operate in respect to the \$200,000 spent on export goods, because disbursements for export goods will call into production no additional workers. Such expenditures will merely prevent some of the workers in the export industries from being forced into unemployment.

But suppose that exports do not decline simultaneously with imports, that for a while they remain undiminished. May not the expansion in incomes originating in the new employment in the protected industries help maintain imports, through increased purchases of goods not subject to prohibitive import taxes, and thus exports? And will this not lead to increased domestic employment?

The net volume of permanent new employment which would de-

### 304 International Trade and Commercial Policy

velop in such a situation would be limited to an amount equal to those portions of the new incomes which were spent on imports, and/or on goods formerly exported. If import duties cause imports to decline by \$1,000,000, if domestic production of the excluded goods expands by an equivalent amount, and if the workers employed in the protected industry spend their entire incomes on imports, a net increase in domestic employment of \$1,000,000 takes place, in the manner previously described. There will be no later decline in exports, and there will be no action of the multiplier. But it is fatuous to assume that 100 per cent of the new incomes will be expended on imports. Only a fraction, and in most countries a small fraction, will be spent in this way.

To go to the other extreme, suppose that all of the new incomes is spent at home. With a multiplier of two, the total increase in incomes will be \$2,000,000. But, since all the new spending is for home-produced goods, exports will eventually decline by \$1,000,000, the amount of the decline in imports, and the action of the multiplier will force a total shrinkage in incomes amounting to \$2,000,000. This will exactly offset the prior expansion in incomes caused by the exclusion of \$1,000,000 of imports. The expansion in employment will thus be only temporary; there will be no permanent improvement.

Let us suppose, finally, an intermediate case: a fraction of the new incomes, say 20 per cent, is expended on imported goods. The total expansion of home incomes will now be not \$2,000,000, assuming the multiplier to be two, but only \$1,600,000, because of the expenditure of \$400,000, or 20 per cent, on imported wares. The spending of this \$400,000 on imports will, however, restrict the eventual decline in exports to \$600,000 and will limit the *total* shrinkage in incomes originating in this unemployment in the export trades to \$1,200,000. There will be, then, an increase in employment equivalent to the difference between \$1,600,000 and \$1,200,000, or \$400,000, just the amount diverted to the purchase of imports.<sup>2</sup>

<sup>2</sup> To the extent that unemployed workers in the export trades curtail their purchases of imported goods, further curtailment in employment in the export industries will occur.

Lord Keynes has pointed out that the prospects for reducing unemployment by means of protective import duties are brightest when the exclusion of imports stimulates new domestic investment in plant and equipment. The sums spent on new investment represent additional spending that is not offset by reduced exports, as are the sums spent on domestic articles which are merely substituted for imports. The addition to employment which results from protection that stimulates new investment should equal the amount of the new investment times the multiplier. There is cogency in this aspect of the argument. Yet periods of widespread unemployment are not periods when business capital is eager to venture into new projects, especially projects whose future existence must depend upon the uncertain protection of a tariff. Furthermore, if the legislature does see fit to dole out tariff favors, it is much more likely to grant such favors to depressed established industries than to industries that are not even in existence in the country. There is little chance that new investment will be made in old industries, because periods of widespread unemployment are invariably characterized by excessive idle plant. Even though new protective duties do encourage investment in new industries, and thus reduce unemployment, however, there must be weighed against the temporary gain the permanent loss involved in sustaining industries poorly adapted to the country. For, unless the protection is made permanent, entrepreneurs will never again be lured into making new investments whose value may be destroyed overnight through the act of a fickle legislature.

Keynes also suggests that protection may improve the unemployment situation through the easy money conditions that may arise from the short-run favorable trade balance and the tendency toward an inflow of gold. But the central bank can do much more to ease the money market than protection can, especially during periods of depression and severe unemployment when bank reserves are large relative to bank liabilities. In any case, the experience of the thirties convincingly proved that easy money conditions are alone insufficient to turn economic depression into recovery and to cure unemployment.

The possibilities which protective duties offer for the relief of

### 306 International Trade and Commercial Policy

unemployment are thus seen to be not great. They are limited by the amount of new expenditures which can be diverted to goods previously exported and to new imports, and by the extremely uncertain expenditures for new investment. While these expenditures will vary from nation to nation, in no case are they likely to be a large proportion of the value of the imports excluded by import duties.

Import duties, moreover, afford no protection against the recurrence of business slumps and future unemployment. No nation can hope to avoid business depressions by insulating itself against world trade; national economies are today too interdependent. Furthermore, the slight chance of alleviating unemployment which a policy of tariff protection offers rests upon an insecure foundation. Other nations may, and in a period of widespread unemployment are likely to, retaliate against the increase in duties by one country by imposing trade restrictions of their own. Such foreign restrictions would quickly reduce the nation's exports and would wipe out all possible employment benefits which protection might bestow.

It must also be kept in mind that the restriction of imports imposes a social cost—the employment of productive resources in such a way that the social dividend is reduced. A given quantity of productive resources will yield a smaller social product when their allocation is directed by the arbitrary dictates of protection than when they are employed in ways dictated by the free choices of consumers expressed in a free market. Widespread unemployment is likely to create in the public mind confusion as to the true objective of economic policy. At such a time the prime objective of policy will be judged to be the curing of this social ill, to the exclusion of other objectives. If the elimination of unemployment were the lone object of economic policy, however, its accomplishment would not be difficult. Just give every man a hoe, a spade, and a plot of land, and force him to support himself. Unemployment would vanish overnight, for there would be more than enough employment for every man, woman, and child in the country; there would also be, unfortunately, a greatly diminished social product. The enjoyment of a bare subsistence would necessitate everyone's laboring from sun-up to sun-down three hundred and sixty-five

days a year. When it is put this way, it is obvious that the elimination of unemployment is never the sole objective of policy. What the people really desire is the elimination of unemployment *and* an increase in the social dividend. The true goal of economic activity is the creation of wealth, not work. If the national income can be increased at the same time that unemployment is reduced, well and good. But a cure for unemployment, and a questionable one at that, which results in a reduction in the national income will be bought at too high a price. There are surer means of mitigating unemployment than protection, means that do not cause a permanent lowering of the standard of living. These include the dissolution of monopolies, the alteration of labor policies that hamper innovation, the removal of taxes that penalize consumption and enterprise, the correction of conditions that are responsible for technological backwardness and irrational organization in some key industry, such as the construction industry, and expenditures on a carefully planned program of public works.

#### TARIFFS FOR RETALIATION AND BARGAINING

Tariffs have at times been advocated as a means of retaliation against tariffs imposed by other nations. This argument may take either of two forms. On the one hand, it is held that, although free trade is the most advantageous policy for every nation, the economic advantages of free trade depend upon its being reciprocal; that a nation suffers injury if its exports are taxed by foreign nations while it permits the free entry of imports from foreign countries. Some argue, on the other hand, that the only way of attaining mutual free trade, or at least a lowering of foreign import duties, is to levy duties upon your own imports so that you will have a tariff which you can offer to reduce, or abandon, in exchange for similar concessions from other nations. This latter view has been ably expressed by Stanley Baldwin, former British Prime Minister: "The only hope we have to secure lower tariffs (from other countries) is to put a barrier around our free trade market and say, 'Anyone who wants to come in here has to give us reciprocal advantages.' You will find that there will be a new spirit in the world, that many of the countries which have never listened to any of the academic or book

## 308 International Trade and Commercial Policy

arguments will begin to realize quickly that business is business, and that they will do better for themselves if they enter into tariff agreements with us. . . .”<sup>3</sup>

The first of these two views, namely, that the advantages of free trade depend upon its being mutual, rests upon a complete misunderstanding of the nature of international trade. The economic benefits that flow from international trade are the benefits of the division of labor. Anything which interferes with the flow of goods between nations restricts international specialization and prevents the most effective utilization of world resources. It is true that high customs duties imposed by foreign countries inflict injury on a given nation; they reduce that nation's exports, and consequently its imports. Fewer goods can be obtained cheaply from abroad than if no tariff obstacles to exports existed; more goods for domestic consumption must be produced at home, at higher costs. But the taxation of a nation's own imports will not correct the injury; it will only add to it. For such taxation will still further restrict the flow of trade and will force an even more uneconomic employment of resources; consumers will be deprived to an even greater extent of low-priced imported goods and will be constrained to buy in their stead higher-priced domestic goods. It is a case of cutting off one's nose to spite one's face.

The second form of the argument is in essence not an argument for protection, but an argument for free trade. A tariff is to be imposed, to be sure, but only in order to intimidate the other fellow into abandoning his tariff. After the foreign tariffs have been removed, or lowered, our tariff will be abolished; virtual free trade will reign.

As thus presented, the argument is attractive. But it overlooks one thing: the danger that the duties may never be removed. Any serious student of the tariff knows that the chances of getting duties removed, once they have been granted, are extremely slight. The immediate effect of the tariff is to encourage home enterprise, and experience teaches that, once interests become entrenched behind a tariff wall, they will fight to the bitter end, and usually successfully, to retain their largesse. Vested interests are difficult to dislodge. Moreover, if the nation is unsuccessful in forcing others to reduce

<sup>3</sup> Quoted by Sir William Beveridge, *Tariffs: The Case Examined*, Longmans, Green & Co., Inc., p. 108.

their duties, it is doubtful whether the national temper will admit defeat and abandon its bargaining tariff. The nation will more probably find itself committed to a permanent tariff. As Beveridge has put it: "The idea that tariffs can by bargaining be made a way to freer trade is not an economic fallacy like most of the common arguments for Protection. It is just a disastrous misunderstanding of human nature."<sup>4</sup>

The only instance in which bargaining tariffs are likely to prove successful is where the mere threat of imposing a tariff succeeds in squeezing concessions from foreign nations, and where the bargaining tariff never comes into being. But the threat to impose a tariff will be quickly recognized by foreign nations to be an idle one, unless a tariff is actually imposed against countries which refuse to grant concessions.

TO ENCOURAGE DECREASING-COST INDUSTRIES AND  
DISCOURAGE INCREASING-COST INDUSTRIES

Some economists have warned that international specialization will, in certain cases, lead to a reduction in a nation's income rather than to an increase. Professor Frank D. Graham has contended that, where country A's comparative advantage lies in a commodity produced under conditions of increasing cost, while country B's advantage lies in a commodity produced under conditions of decreasing cost, specialization will work out to the disadvantage of country A.<sup>5</sup> Under free trade conditions, where each country specializes according to its comparative advantage, the unit costs of *both* commodities will rise in country A as a result of (1) the contraction of the decreasing-cost industry and (2) the expansion of the increasing-cost industry; while in country B the unit costs of both commodities will fall, due to (1) the expansion of the decreasing-cost industry and (2) the contraction of the increasing-cost industry. Since the costs of both commodities rise in country A, and fall in country B, the terms of trade may be little changed as a result of trade. But trade will cause country A to suffer, for, although the terms of trade may not have altered to her disadvantage, the

<sup>4</sup> *Ibid.*, p. 113.

<sup>5</sup> See "Some Aspects of Protection Further Considered," *Quarterly Journal of Economics*, Vol. XXXVII (1923), pp. 199-227.



### 310 International Trade and Commercial Policy

costs of producing her export commodity have risen. If the production of the export commodity (the increasing-cost commodity) is pushed far enough, the costs of production may be raised so high that less of the imported article is obtained from a given quantity of domestic resources through trade than could have been obtained had the resources, that are devoted to producing export goods, been applied directly to producing the imported article at home.<sup>6</sup> It would therefore appear that country A would benefit from a policy of protection, which would prevent specialization from proceeding so far. The position of country A may perhaps be likened to that of some countries which specialize in the production of raw materials.

The logic of this argument is unimpeachable, *if one grants the assumptions on which it is built*. Yet it is the dubious validity of the basic premises which makes conjectural any advantages which may be expected to flow from protective duties in such a case. In the first place, the belief that import duties may be employed to stimulate the growth of decreasing-cost industries presupposes the existence of a *law* of decreasing costs and the ability to prophesy in what fields of production, or over what stages of growth, that law may be expected to operate. While most economists would grant that decreasing costs, in the sense of a lowering of costs with the expansion of the output of an industry, do operate at times, few would go so far as to agree that their operation is commonly predictable.

It was pointed out in Chapter VI that internal economies, i.e., those realized from the expansion in the size of the individual firm, could hardly be expected to provide the primary stimulus to decreasing costs in industry. If lower costs could be attained by enlarging the business unit, and if competition dominates the industry, businessmen would enlarge their productive units without waiting for an expansion of the total market. The existence of many competing enterprises is a strong indication that no further economies are to be gained from an increase in the scale of production. The primary impulse to decreasing costs must come, then, from external economies. But external economies are so vague, they occur so

<sup>6</sup> A clearer picture of the situation may be obtained from the figures presented in Professor Graham's article, *op. cit.*, pp. 204-212. No attempt to reproduce these figures is attempted here because of the limitations of space.

irregularly and so infrequently, and they are so difficult to predict that it appears unwise to adopt a policy of protection upon the possibility that such economies will actually emerge. The gain from protection is in this case problematical, but the loss is certain.<sup>7</sup>

The fear that specialization in extractive pursuits will eventually lead to the impairment of the standard of living of any country so specializing overlooks the possible counterbalance of external economies, even in the extractive industries. To be sure, diminishing returns from natural resources will eventually be encountered, although perhaps not as quickly as is often supposed. But, as agriculture and mining expand, offsets to diminishing returns appear. Railways and highways are constructed; it pays to undertake large-scale irrigation and drainage projects; specialized banking and credit facilities are developed; governments establish research laboratories and experiment stations, build fertilizer plants, and foster rural electrification; and the enlargement of the productive unit, or the formation of cooperatives, may make possible the wide use of labor-saving machinery.

Another premise whose soundness is open to question is that which holds that the contraction of an industry which has previously passed through a phase of decreasing costs will cause the forfeiture of the internal and external economies already realized; in other words, that the cost curve of the industry is reversible. It is not at all certain that the contraction of an industry will result in the disappearance of these economies. Where the industry is still competitive, contraction will not mean that the size of the productive

<sup>7</sup> An analogous, but somewhat narrower, form of the argument has been advanced by certain interests in England in recent years. Exclude from the domestic market the competing foreign products of industries in which the economies of mass production bulk large, so that domestic firms may attain optimum size, and possibly succeed eventually in reducing costs below those of foreign competitors.

But, as Beveridge observes, this presumes that there are industries which are ripe for large-scale production and that none of the manufacturers in these industries are prepared to undertake the necessary expansion. He points out, in addition, that, while a tariff will cause the total domestic production of a particular industry to expand, it will not necessarily bring about larger-scale production. Larger total production *may* be achieved by many small-scale producers, as well as by a few large-scale producers. The former tendency has revealed itself in Australia, and in the motor industry and the coal industry in Great Britain. See Beveridge, *op. cit.*, pp. 95 et seq.

## 312 International Trade and Commercial Policy

unit will shrink. Rather, the weaker firms will be forced to the wall, and those that survive will remain at optimum size and will retain their internal economies. The same will be true of those external economies which consist of the internal economies of ancillary industries. The contraction of the main industry may force the contraction of subsidiary industries, although some subsidiary industries may be supplying several main industries and may therefore avoid any significant shrinkage. But, where competition prevails in the subsidiary industries, contraction will not cause a reduction in the average size of the firm; instead, the weaker firms will be eliminated. Those that remain will continue at optimum size. Finally, those external economies which do not comprise the internal economies of auxiliary industries are not likely to disappear; most of them are durable. This is certainly true of a large and skilled labor force, the fundamental research and the practical solutions to various technical problems, transportation and communication systems, and banking and credit facilities.<sup>8</sup>

Where the industry that is the candidate for protection is controlled by a single producer, a contraction of the market will reduce the output of the firm and may cancel some of the internal economies. Yet to protect a domestic monopoly only encourages the exploitation of consumers. Furthermore, one of the chief advantages of unrestricted international trade is that it widens the market and thereby permits the fuller realization of the advantages of large-scale establishments. By reducing imports, protection might even restrict the market of the monopoly in question. If foreign competition is keen, and if foreign producers are realizing lower costs as their market expands, it is also open to the domestic producer to widen his market in the same way, viz., by invading the export market. With an expanded market, the local producer may attain lower costs, as the foreign producers do, and thus continue to compete. If the costs of the domestic producer are still above the market price after the point of minimum costs has been reached, however, protection will be unavailing. Costs are at a minimum, and any change in size can only cause them to rise.

Even if one should grant these disputed assumptions, another

<sup>8</sup> See Karl L. Anderson, "Tariff Protection and Increasing Returns" in *Explorations in Economics*, pp. 157-168.

limitation upon specialization develops as a result of the international expansion of markets. The expansion of any branch of production will make scarcer those factors of production which are used in large quantities by that branch, and will result in higher prices for those factors. Contrariwise, the contraction of any field of production will make less scarce those factors largely used in that field, and will cause the prices of those factors to decline. As the costs of the increasing-cost commodity rise in the country specializing in its production, costs of the same commodity fall in the other country, as the demand for the special factors decreases and the margin is drawn in. An increase in the output of the decreasing-cost commodity in the one country is accompanied by a growing scarcity of, and higher prices for, the factors that are used in abundance in producing it, while in the other country the contraction of the decreasing-cost industry involves an increasing abundance of, and lower prices for, these same factors. These forces tend to set limits to specialization and international trade. The point may well be reached at which the increasing-cost commodity will be as cheap in the importing as in the exporting country; no further imports of the article into the former country will then be made. Similar limits to imports of the decreasing-cost good into the other country may appear.

#### TO ACCELERATE THE RATE OF CAPITAL ACCUMULATION

Some economists maintain that the protection of home industries will cause the output of industry as a whole to increase due to the acceleration of the rate of capital accumulation.<sup>9</sup> A tariff increases the profits of enterprise in the protected industries; and, since profits are a form of income which produces an unusually large amount of saving,<sup>10</sup> protection is likely to accelerate capital accumulation and thus increase the output of goods.

The fallacy of this reasoning lies in the confusion of total profits in all industry with profits in the protected industries. A tariff will increase the profits of the protected industries; in fact, the common complaint of tariff lobbyists is that without a tariff these industries will

<sup>9</sup> See A. S. Johnson, "Protection and the Formation of Capital," *Political Science Quarterly*, Vol. XXIII, (1908) pp. 240-241; and Sumner H. Slichter, *Modern Economic Society*, p. 785.

<sup>10</sup> In the United States, it is estimated that about 40 per cent of profits are saved.

### 314 International Trade and Commercial Policy

realize no profits whatsoever, that they will in all probability not even be able to cover their costs. But under competition, these industries, even behind a tariff wall, will earn profits no larger than those earned in unprotected industries. For, if they should, capital and enterprise would shift into the protected fields, and the increased output would force profits in these industries down to the levels prevailing elsewhere. Few would seriously advocate protection for the purpose of enhancing monopoly profits. Contrary to the contention that a tariff will accelerate saving, however, protection is more apt to diminish saving, because it reduces the standard of living. It is contrary to experience to expect that people will save as much when their real incomes are low as they will when their incomes are higher.

Even if the volume of saving could be increased by means of protection, the desirability of increasing that proportion of a nation's income which is saved may be open to question. A nation can save too large a portion of its income. This has undoubtedly been true of Russia under Communism, where the dearth of consumers' goods is an all too familiar story. Recent developments in the theory of the business cycle suggest, furthermore, that business depressions may be generated by the tendency of savings to increase faster than investment outlets for these savings. The stimulation of investment by public works construction or an easy money policy and the *curtailment* of saving by progressive income taxation have both been recommended as policies which promise to keep industrial activity on an even keel whenever business shows signs of receding.

#### TO ENCOURAGE THE MIGRATION OF CAPITAL AND LABOR

Certain protectionists, notably Alexander Hamilton and Richard Schüller, have denied the central free-trade thesis, viz., that tariffs always occasion an irrational shifting of production and never cause an increase in the national income. Hamilton and Schüller both maintained that tariff protection might be employed to increase the productive powers of a nation by encouraging the growth of population and an increase in capital. They insisted that a country's supplies of the factors of production are not fixed, but that both capital and labor can, and do, migrate. They held that capital and labor could be attracted to a nation through a carefully designed policy

of protection and that the larger labor supply and the greater capital equipment would contribute toward producing a more abundant national income.

It is true that the erection of protective tariffs may lead, and actually has led, to an importation of capital. Protection may lead to the establishment of new industries which are financed by foreign capital, or it may induce foreign firms to establish branch plants behind the tariff wall and to bring workers and machinery into the country to equip and staff these plants. But the acquisition of more capital by a particular industry is not necessarily the same thing as a net addition to a country's stock of capital; nor does a net addition to a country's stock of capital necessarily mean a larger national income.

Spain may be able to nurture a domestic automobile industry by placing a tariff on imports of automobiles, and may even induce the importation of the machinery and the other equipment necessary for the manufacture of automobiles. But the cessation of imports of automobiles will cause her exports—fruit, wines, copper, pyrites, cork—to decline. These industries will therefore be forced to contract, and some of the capital used by these industries will become idle, and possibly valueless—except as junk. Some of this abandoned capital equipment may even be exported, if the development of competing industries is now encouraged abroad as a result of the decline in the exports of foreign nations. After the world has become adjusted to the new situation, Spain may find that she possesses no more capital than before, despite her importation of capital.

But, even if Spain's stock of capital becomes greater as a result of the tariff, Spanish consumers will be worse off. The prices of automobiles will now be higher, because the conditions of production will be less favorable at home than abroad; the national dividend and the incomes of consumers will fall. There is no gain counterbalancing this loss, although the country possesses more capital.<sup>11</sup>

In addition, the national income will be still further reduced in

<sup>11</sup> One exception to this statement must be made. The immediate loss may be offset by a future gain if it turns out that protection has been successfully applied to an infant industry. The shortcomings of infant-industry protection have been explained in the preceding chapter.

## 316 International Trade and Commercial Policy

future years, for interest and amortization payments must be made to creditor countries.

This should not be taken to mean that capital imports are not desirable. On the contrary, the very building-up of most undeveloped young nations has depended upon large imports of foreign capital. But this capital has been attracted by high interest rates which have reflected promising investment opportunities; it has not been necessary to impose protective tariffs in order to attract it. It has gone to build up industries in which the capital-importing nations possessed undeniable advantages; industries so poorly adapted to a country that they could hope to survive only by the grace of tariff protection have proved to be less alluring to foreign capital.<sup>12</sup> The healthy industrial structure which has resulted from these capital imports has facilitated the payment of interest and the repayment of principal on the foreign loans, the while these countries have enjoyed higher living standards.

Granted, however, that tariffs are not likely to increase the national income significantly by attracting capital from abroad, may not tariffs be used to encourage the immigration of persons and thus build up the home population? Possibly. Business men and skilled workers, in particular, may be attracted by the expansion of specific industries. It is doubtful, however, whether any sizable migrations will be stimulated by tariffs. The great migrations of history have been motivated by religious persecutions, political persecutions, or the quest for more favorable economic opportunities. Where the main motive has been to better one's economic well-being, the proximate cause of immigration has been the existence, or the prospects, of higher incomes in the chosen land than in the fatherland. Insofar as tariffs diminish real incomes in distant lands, emigration to those lands loses some of its appeal.

But, if tariffs *could* cause population to increase, how desirable would such an increase be? For sparsely settled countries, an increase in population is desirable, at least on economic grounds. It means larger markets, production on a greater scale, and consequently more efficient production. But, after population has in-

<sup>12</sup> Some American corporations have been induced to erect branch plants in foreign countries as a means of getting over tariff walls erected by those countries.

creased to a certain point, a further increase results in overcrowding. The economies of large-scale production become exhausted and are more than offset by the operation of diminishing returns; production costs rise, and living standards fall. There are probably few countries in the world today that could support a much larger population without meeting sharply diminishing returns from land. During the 1920's and the 1930's the "have-not" countries—Germany, Italy, and Japan—kept the world well informed of the draw-backs of over-population. Nevertheless, while complaining of over-population, these countries displayed remarkable ingenuity in devising methods of encouraging a higher birth rate. The reason for this apparently irrational encouragement to population growth was the desire for a large population as the basis for a great military force.

#### TO AVOID EXCESSIVE INDUSTRIALIZATION AND SPECIALIZATION

The dwindling importance of the agricultural population, which is noted in industrial countries as they become more industrialized, has caused many to utter warnings that industrialization may go so far that it impairs the national welfare. Many Germans viewed with alarm the relative decline in the German agricultural population after 1870. Between 1871 and 1895, the German agricultural population declined from 47.3 per cent of the total population to 33.6 per cent, and by 1925 the percentage had dropped to 23.0. This decline in the importance of German agriculture made Germany more and more dependent upon imports of foreign foodstuffs and raw materials. The big Prussian landowners succeeded in securing protection for German agriculture in 1879; but, despite several increases in agricultural duties before the turn of the century, Germany's dependence on foreign supplies continued to grow, until several German economists, notably Oldenburg, Pohle, and A. Wagner, predicted that a disastrous future awaited Germany unless the decline in the agricultural population were halted by even higher agricultural duties. Nor has concern over increasing industrial specialization been confined to Germany.

(1) The attack against industrial specialization has taken three distinct lines. The first of these is based upon sociological rather than economic grounds. It contends that the crowding of the population into urban areas gives rise to unhealthy slums and unsatisfac-



### 318 International Trade and Commercial Policy

tory factory conditions; that a one-sided industrial development is attended by a loss of cultural values. The prosperity of a large agricultural population should be preserved, for a prosperous and permanent land-owning and farming class is an essential requirement for the "welfare and the enduring economic and social, as well as physical, ethical, cultural, and political soundness and security of the whole nation."<sup>13</sup>

The merits of this argument are not for the economist to appraise, for to determine which of two social goals is the more desirable is not a subject for economic analysis. The economist can merely point out that the building-up of an agrarian class by means of protection will involve the cost of a smaller national income. It is for the people to decide whether the end is worth the price. It is probably true, however, that the evils of a too rapid industrialization and its ill effects upon the health and morals of the people may be more cheaply, and perhaps better, countered by other means, e.g., slum clearance, schools, health, accident, and old-age insurance, medical and dental clinics, playgrounds, etc. The question may also be raised whether the social and cultural advantages enjoyed by most urban dwellers are not superior in many respects to those available to many inhabitants of rural areas.

(2) The second line of attack against specialization insists that international trade does not even bring about the maximization of the national income, because it makes the domestic economy interdependent with foreign economies and consequently subjects economic activity at home to industrial shocks and fluctuations abroad. These economic fluctuations are characterized by lengthy periods of widespread unemployment, which result in a serious loss in income. By encouraging a wider diversification of industry and a greater degree of self-sufficiency, it is claimed, the dependence upon foreign economies would be diminished, business fluctuations would be fewer and less severe, the national income would be greater in the long run, and the domestic population would gain in many other ways from the greater economic stability. Protection would, of course, be the most desirable means of creating this industrial diversification.

<sup>13</sup> Wagner, "The Agrarian State vs. the Manufacturing State," in Taussig's *Selected Readings in International Trade and Tariff Problems*, p. 357.

It must be pointed out, in reply to this contention, that economic fluctuations abroad which may affect domestic conditions are of several types. Disturbances may have their origins in wars, in cyclical fluctuations in business, or in international migrations of industry. For most nations, the attainment of such a high degree of self-sufficiency as would make avoidable serious internal readjustments following the outbreak of a major war would force such a drastic lowering of living standards as to be unthinkable. A nation that possesses such a diversity of resources as the United States might, to be sure, further insulate itself economically from the rest of the world at a much smaller long-run cost than most nations. But to do so would involve such a drastic immediate reorganization and reallocation of productive factors as to cause persons in power to pause. Any wholesale raising of prohibitive trade barriers would in all likelihood have results as deleterious as those produced by a wholesale removal of tariff barriers. It should also be remembered that it is extremely difficult, if not impossible, for any world power today to avoid becoming entangled in a major war; and any entanglement in war invokes radical economic disturbances. The way to avoid economic disruptions which have their origins in war is not to raise trade barriers, but rather to create some form of world political and economic organization which will make future wars impossible. The recent conflict has impressed upon the people of the world the dire urgency of finding some means of abolishing such an intolerable and unjustifiable institution as war, before war annihilates civilization. The United Nations Organization is the keystone of this hope. The very tariffs and other trade restrictions which protectionists advocate are fertile causes of international armed conflict. Nations that feel they are being unfairly excluded from foreign markets and unrighteously denied access to foreign sources of vital raw materials, or are permitted to acquire such materials only at extortionately high prices, have little compunction in seeking the redress of their grievances through war.

There is little evidence to show that high tariff countries like the United States and France have suffered less from cyclical disturbances to business than low tariff countries like Great Britain and Holland. Certainly, no country suffered a higher degree of unemployment in the depression following the breakdown of 1929 than

## 320 International Trade and Commercial Policy

the United States, although the percentage of her national production which was sold in export markets was but a fraction of that of the United Kingdom or the Netherlands.<sup>14</sup> Cyclical fluctuations are deeply rooted in capitalistic economy; they are not a mere offshoot of international trade. In fact, a national economy which is tied to other national economies through trade may find on occasion that foreign markets act as a stabilizer for the domestic economy; a foreign market may do much to sustain domestic production at a time when domestic demand is falling off. The widespread depression which hit Europe in 1890, and seemed certain to engulf the United States, failed to depress industrial activity in this country because poor harvests in Europe happened to coincide with bumper harvests in America, and American farmers were able to sell abroad abundant crops at high prices; the spending of farmers sustained American business. There are other devices which offer more promising prospects of reducing the violence of business fluctuations than tariffs, e.g., monetary and credit controls, the removal of restrictions that hamper investment and production, public works programs, and unemployment insurance.

Secular changes in international competition and in the location of industry admittedly cause disturbance and force readjustment. But competition is the fountain of progress. To stifle competition by permitting domestic concerns to withdraw into the sanctuary of a protected market will retard progress, foster stagnation, and encourage monopoly; standards of living will inevitably suffer. In any case, tariffs are of no avail in protecting industries whose main markets lie in foreign countries. Where protection causes imports to decline, adjustments are not avoided; they are merely shifted to export industries.

There is one situation in which it appears that a wider industrial diversification might assure a nation a greater degree of economic stability. The economies of certain young nations are inordinately dependent upon foreign sales of a single product, or of a narrow class of products, for which the demand is inelastic. The economy

<sup>14</sup> The United States exported in 1928 5.7 per cent of her national production. The corresponding figure for the United Kingdom was 19.2 per cent in 1924; for the Netherlands, 30 per cent in 1925; and for France, 24.4 per cent in 1928.

of Chile, for example, is built on exports of copper and nitrates; Brazil's, on exports of coffee; Argentina's, on exports of wheat and meat; Cuba's, on exports of sugar. In periods of world depression, the prices of these primary products decline more than the prices of the manufactured goods which such countries must purchase largely abroad. As a result, living standards in these countries decline precipitously at such times. The establishment of industries to manufacture various consumers' goods within these countries would probably mean that the living standards of their populations would suffer less severely during times of economic depression, and might well be worth the cost of protection. But it is not to be expected that greater industrial diversification will completely insulate the economies of these countries against world economic disturbances; it can, at best, only mitigate the internal repercussions of such external cataclysms. And diversification will not be costless; consumers will have to pay higher prices for the domestically-produced goods than for the imported goods.

(3) The third line of attack upon international specialization pictures a catastrophic future for those nations which continue to expand their industrial plant at the expense of their agriculture. A continuation of this trend, wrote Wagner, can only mean that, as the young nations which now supply the older nations with foodstuffs and raw materials seek, in their turn, to become industrialized, and as the populations of these young nations grow, the older nations will discover that they can no longer obtain food and raw materials from these sources nor sell to these young nations their own manufactures. For, as the populations of the young nations grow, their export surpluses of raw materials and foodstuffs will diminish, while their rising tariff walls will make it increasingly difficult for foreign manufactured goods to enter their national markets. Sooner or later, then, the older countries will have to face a disastrous reversal of their previous development. While the absorption of people from the rural areas by the cities is relatively easy, the opposite process is extremely difficult, because a generation or two of city life makes people mentally and physically unsuited for agriculture. Population may even have increased to such an extent under industrialization that the nation may now find it impossible to raise from her own soil sufficient food to support such a population. Thus, the export

## 322 International Trade and Commercial Policy

of capital goods spells economic disaster for the capital-exporting countries.

Although this is another argument which cannot be subjected to economic analysis, certain considerations make the predictions of the German prophets appear unduly pessimistic.<sup>15</sup> Economic history reveals that the spread of industrialization does not mean the loss of export markets by the older industrial countries. The industrialization of western Europe, the United States, and, more recently, Asia has witnessed the simultaneous increase in exports of English manufactured goods; today, some of England's very best customers are her manufacturing competitors—the United States, Germany, France, and Italy. It is not at all surprising that manufacturing nations should find their best customers in other manufacturing nations. In the first place, manufacturing nations tend to develop manufacturing skills in different, not necessarily in competing, fields. The farther the division of labor goes, the more true this becomes. Agricultural countries do not become industrialized all at once; their industrialization proceeds by stages. They begin by producing semi-finished products and goods of coarser grade, which demand no skilled labor. The finer qualities of goods and the instruments of production, such as machinery, must still be imported. Industrial and technical development does not stand still in the older countries; these countries turn to the production of more complicated manufactures—machines, electrical apparatus, motor vehicles, chemicals, etc. Their superiority in fields requiring a high degree of skill and technical perfection is maintained. Second, industrial nations in general support large populations which enjoy relatively high standards of living and consequently afford much better markets for manufactured articles than countries with sparse populations, or countries with large populations which have low incomes, like China and Japan. And third, only industrial nations can make any extensive use of many highly processed goods. England makes extensive use of American typewriters, adding machines, and automatic looms; but it is difficult to imagine the extensive use of such products by present-day Ethiopia, Hungary, Venezuela, or Thailand. The export of

<sup>15</sup> For an effective rebuttal of this argument see Lujo Brentano, *Die Schrecken des überwiegenden Industriestaats*. Sections of this book are reproduced in Taussig, *op. cit.*, pp. 392–416.

capital goods has provided a profitable basis for an enlarged international trade in the past; there is no reason to expect a different result in the future.

The fear that older industrial nations will *suddenly* see their sources of raw materials and foodstuffs disappear, and that they will consequently be forced to undergo the hardships of shunting factors back into agriculture, appears to be not too well founded. The growing scarcity of agricultural products will make itself felt in gradually rising prices for these goods, and these rising prices will make more and more attractive the shifting of productive factors into agriculture, as compared with industry—both in the old and in the young countries. This shifting of productive agents into agriculture will not involve a sudden displacement of agents already established in manufacturing; rather, new savings, young labor, and fresh enterprise will gradually be drawn into the extractive industries by the prospects of attractive rewards. A rise in the prices of agricultural goods will slow up industrialization in the young countries, because it will make agriculture relatively more attractive than industry for new enterprise.

The economic development of the United States is of interest in this respect. A producer and exporter of foodstuffs and raw materials from the beginning, she experienced after the Civil War an industrial development unmatched in history, with the possible exception of German development after 1870—a development which placed her in the very front rank of industrial nations. Yet today, more than 40 per cent of her exports are raw materials and foodstuffs, while another 12 to 15 per cent are semi-manufactures, i.e., materials partly processed in this country, such as petroleum products, refined copper, lumber, and iron and steel products. There appears to be little likelihood that industrialization and further population growth will cause any contraction in these fields. Whatever contraction does take place will come only because too low prices for the products of such industries—the result, in part, of insufficient foreign demand—make continued operation unprofitable for many producers. Both World Wars have demonstrated how the output of agricultural products will respond to higher prices, in Canada, Australia, and Argentina as well as in the United States.

Haberler has called attention to two important developments that

## 324 International Trade and Commercial Policy

tend to belittle the fears of the pessimists, that industrial nations will be faced with an insufficiency of foodstuffs and raw materials in the future. The first is the application of improved techniques and mechanization to agriculture, which have greatly increased agricultural output and reduced the labor force necessary to produce a given output; there can now be no question of a shortage of raw materials. The second is the decline in the rate of increase of population in agricultural as well as in industrial nations. There seems to be little danger that agricultural countries will fail to continue producing surpluses of foodstuffs and raw materials for export to the older industrialized nations.

### TO MAINTAIN OR ESTABLISH INDUSTRIES ESSENTIAL TO NATIONAL DEFENSE

Every war brings home to all nations the fact that certain products essential for the conduct of war are not produced at home but have to be imported. As a sound policy of national defense, it is urged by many that industries essential to national defense be established and maintained at home even if the erection of protective tariffs or the payment of subsidies is necessary to support such industries. In 1921, free-trade England passed the Safeguarding of Industries Act, which imposed protective import duties on such articles as optical glass, laboratory porcelain, certain scientific instruments, and various chemicals—essential war goods for her supplies of which she had been almost entirely dependent upon Germany at the outbreak of war in 1914. After the Nazis rose to power in Germany in 1933, the German government granted large subsidies for the construction within Germany of plants to produce synthetic oil and artificial rubber, two commodities for which she was well-nigh completely dependent upon the outside world. Earlier, Wagner had urged that Germany establish protective agricultural tariffs; he pointed out that in case of war she might be cut off from her foreign supplies of food and be starved into submission by enemy blockade. The war effort of the United States was seriously crippled in 1942 when Japan cut her supply lines with Malaya and the Netherlands India, her sources of vital tin and rubber.

The national-defense argument is another argument which cannot be evaluated in terms of the maximization of income. The im-

portance of national defense cannot be overemphasized. Adam Smith himself, the father of free trade, admitted that, "Defense is more important than opulence." But what are the "key industries" of national defense? A more careful investigation would reveal that few industries can be excluded from this category. Such apparently non-essential industries as the tobacco and movie industries may be vital factors in maintaining home morale, than which there is nothing more important in a war of attrition, for a collapse behind the lines will bring with it a collapse on the field of battle.

For a few nations virtual self-sufficiency in wartime may be possible. A country as richly endowed by nature as the United States, or Russia, may be able to make up her natural deficiency in some vital material by nurturing a domestic substitute industry behind a protective tariff; the gain in security may be considered to be well worth the economic cost. But for most nations self-sufficiency in wartime is unattainable; deficiencies in vital materials cannot be made up by domestic production. Even Great Britain, with her world-wide empire, came perilously close in both World Wars to having her industries strangled and her population starved into submission by the counter-blockade of the German submarines and the Luftwaffe. Despite the subsidies to her synthetic oil industry in the 1930's, Germany was unable to overcome completely her natural shortages of fuel and lubricating oils when war came. There is a danger to national defense, however, in the use of protective tariffs to encourage the exploitation of limited native stores of minerals. Protection may encourage exploitation during peace-time to such an extent that the reserves are exhausted before the nation becomes embroiled in war.

As long as the nations of the world resort to war as a means of settling their disputes, so long will they strive for economic self-sufficiency. Protection is only one of the peace-time wastes which are a by-product of war.

#### TO REDUCE REAL WAGES

A special form of the unemployment argument for protection appeared in England after she had readopted the gold standard in 1925. Widespread unemployment was commonly attributed to too high wages; the obvious way to remedy unemployment was, then,



## 326 International Trade and Commercial Policy

to reduce wages. But, unfortunately, the trade unions were so powerful that direct wage reductions were out of the question. It was therefore urged that real wages be lowered in such a way that the unions would be unaware of the reduction; this was to be accomplished by imposing a flat tariff of 10 or 15 per cent on all imports, thus raising prices and the cost of living.

This proposal has evident weaknesses. Entrepreneurial decisions are, of course, based upon the prospects of profits, which in turn depend upon the relation between costs and selling prices. The wages which affect entrepreneurial costs are, however, money wages, not real wages. If entrepreneurs must pay the same money wages as before for the same services, they will not be benefited at all by having their employees forced to pay higher prices for the goods they consume, unless the rise in prices extends to the prices of the entrepreneurs' own products. However, if the prices of domestic products rise only sufficiently to compensate for the higher prices of imported materials, the profitability of domestic enterprise will not be enhanced. Higher domestic money costs will, moreover, tend to diminish exports and thus aggravate unemployment.

The use of protection to lower real wages assumes that laborers will be satisfied with their former money wages in the face of rising prices. This may well prove illusory, for unionization has made organized labor very much aware of the losses which rising prices inflict upon its membership. Labor unions are therefore ever alert to repair their impaired fortunes by insisting upon increases in money wages.

### WHY TARIFFS PERSIST

With the exception of the infant-industries argument, the arguments for protective tariffs rest upon shaky foundations. Most of them are based flatly upon fallacies. Some seek protection only in unusual and emergency conditions, such as for the relief of widespread unemployment. But, where protection holds any promise of meeting the emergency successfully, other more direct and less dangerous means are usually available for attaining the same ends. Other arguments admit that protection involves an immediate cost to a nation in the form of lowered standards of living, but contend that it promises future, if uncertain, economic benefits which will

more than counterbalance the temporary (but certain) loss. Still others admit that protection will cause a lowering of the national income, but maintain that other ends are more important than the maximization of the national income, e.g., the development of defense industries, or the building-up of numerous, diverse social and economic classes within a nation.

The situations in which the imposition of protective tariffs may be justified are few; they call in general for only temporary tariffs; and they can usually be more efficiently met, and at a lower cost, by other devices. Even the protection of infant industries applies properly only to selected industries, and to these only during a certain stage in the economic development of a country. In practice, the resort to protection for the purpose of nurturing young industries is so beset with pitfalls that most economists would hesitate to bring it into use. What it calls for is selective and temporary protection. But history reveals that there is no such thing as selective and temporary protection. Once the Frankenstein's monster of protection is given life, it feeds upon the economic body like a cancer, rapidly outgrows the role originally assigned it, and achieves immortality!

Why is it, then, that nations are so willing to adopt a system whose results are thus generally harmful and which, when applied to the relatively few situations where it might serve some desirable purpose, is prone to grow out of control and to fasten itself like a leech upon the social organism? What is the powerful magic which induces nations to ignore the irrefutable logic of the free-trade case, so that today there is not an important nation in the world that has not retired behind a protective tariff wall?

Chief among the forces which give vitality to the system of restriction is the self-interest of special groups of producers. In some instances, tariff legislation has actually been the occasion for parliamentary corruption. More frequently, legislators have been willing to sacrifice the general interest in order to placate powerful business interests among their constituencies, and thus ensure their own personal reelection to office. For, while the general consuming public suffers from protection, special groups profit therefrom. As one writer has expressed it, "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

## 328 International Trade and Commercial Policy

*individually.*"<sup>16</sup> Where a concentrated gain is accomplished by a diffused loss, the former will usually provide a stronger incentive to political action, regardless of the balance of gain or loss to the entire community. Moreover, the real cost of the tariff is seldom clearly understood even by those most strongly affected by it, such as entrepreneurs and employees in the export industries, to say nothing of politicians and the general public.

Although consumers rarely comprehend the costs of protection to them, the sectional beneficiaries of protection perceive all too clearly the benefits which protection bestows upon them. Who, for example, benefits from a tariff on cotton textiles? The textile entrepreneurs, of course. But they are not the only ones. Textile workers will be assured jobs, and will perhaps receive wage boosts; local merchants, tradesmen, professional men, neighboring truck farmers, and transportation agencies also can look forward to a longed-for increase in business and larger incomes. And who will dare to destroy the bonanza which these simple duties promise to yield? Consumers? Yes. But consumers rarely have any effective organization. After all, what is everybody's business is nobody's business. Export industries, whose foreign shipments are curtailed by high import duties, are also interested in tariff reform. Export interests have not, however, dared be too active in such a cause.

Another force which has lent popular support to tariff legislation is its nationalistic and demagogic appeal. The case for free trade is primarily rational and unspectacular. To appreciate it calls for a broader and deeper understanding of economics than most people possess, or care to acquire. But to the mass of the people, it seems plausible that, if imports are kept out, there will be more work for the home population—at least for specific groups; that domestic wages will not be endangered by the "starvation" wages paid abroad; that money will be kept at home; that domestic producers will have a better market for their goods. The most fallacious of the protectionist arguments are the ones which carry the greatest popular appeal.

The growth of protectionist sentiment has been associated with the belief that what one nation gains another nation must lose. When this belief is combined with the notion that a country gains

<sup>16</sup> Barrett Whale, *International Trade*, Thornton Butterworth, Ltd. (1934),

from its exports, it seems to follow that a country must lose from its imports. And why should a country penalize itself to benefit another country? It is no coincidence that the line of customs houses is always found at national boundaries. The raising of tariff barriers all over the world after 1929 betokened the recrudescence of the spirit of nationalism, as well as the groping for a defense against an intolerable deflation.

Once protection has been introduced, on however small a scale, it tends to gather momentum and to extend to wider and wider fields. When protection has been granted to some industries, it seems unjust not to extend it to others. In fact, if some industries receive protection, it may appear not only equitable, but necessary, to grant it to others. For protection tends to raise the prices of the products protected, and there are products of few industries which do not enter, directly or indirectly, into the production costs of other industries, either as raw or semi-finished materials, manufacturing tools, agents of transportation, or items affecting the costs of living of the workers. Where protection to one industry causes the costs of another industry to rise to the point where they threaten profit margins in the latter, the usual, and easy, way of granting relief is to extend protection to the injured industry, not to remove protection from those industries which already enjoy it.

Support for an extension of import duties to other industries is not difficult to secure in legislative chambers, for no object of legislation has been more frequently subjected to log-rolling than the tariff. The reelection of each legislator is dependent upon the goodwill of only the people of his own state, or district; it does not depend upon the good will of the electors of the nation as a whole. And nothing builds good will among a legislator's constituents so readily as looking out for local interests. The political career of any representative who fails to work for the protection of important business interests in his district, when these interests are seeking protection, is likely to be short-lived. More than that, the good old principle, "you scratch my back and I'll scratch yours," solicits support for narrow sectional interests even from parties not directly interested in the specific protection. Although the representative from Massachusetts may have no interest in getting a tariff imposed on sugar for the benefit of the sugar producers in Louisiana, and may even think such protection undesirable, he will, nevertheless, be willing to vote

### 330 International Trade and Commercial Policy

for a sugar tariff if by so doing he can obligate the Louisiana representative, in his turn, to vote for a tariff on textiles, which will benefit the textile interests of Massachusetts. Strongly entrenched and richly financed lobbies are constantly on the alert for any opportunity to press Congress for tariff increases and to resist every attempt to lower duties.

The fear of the consequences of the removal of duties of long standing has caused vested interests to support vigorously the extension of protection to other industries, and thus to win allies. These vested interests form a not inconsiderable body in a country which has been so generous with its tariff favors as the United States. Not only manufacturers and workers in protected industries, but tradesmen, merchants, professional men, farmers, and transportation agencies which serve communities dependent upon protected industries sense in the removal of protection from a local industry the direct loss of their own livelihood. There is no denying that the wholesale and indiscriminate removal of tariffs would cause serious economic dislocations and widespread hardships—costs which would have to be deducted from the estimated gains to be derived from a greater degree of territorial division of labor. In fact, the disturbances to industry and the losses to individuals, which would almost certainly follow a complete and sudden removal of tariff protection, appear to be so appalling that few would seriously recommend such a course. The dependence of many industries upon protection is, however, unquestionably overrated. Some industries well able to compete abroad still cling to their duties, and fight for them when necessary. In other industries, a few, high-cost firms would go to the wall if protection were taken away, but the bulk of the firms in the industry could probably exist without it. Should the community be asked to subsidize these high-cost firms? There can be little doubt that many duties in the American tariff could be reduced considerably, and others withdrawn entirely, without causing serious injury to anybody.<sup>17</sup>

#### THE TARIFF AND AMERICAN INDUSTRIAL DEVELOPMENT

Protectionists are prone to point to the phenomenal industrial growth which the United States experienced after the Civil War and

<sup>17</sup> See Ch. XVII.

to attribute this to the high protective tariff which prevailed during these years and had its origin in the exigencies of Civil War finance. Yet it does not follow that, because a high tariff was in effect throughout this period, the tariff caused this growth and prosperity. Unquestionably, industrialization in the United States was accelerated by high protection. But the effects of the tariff upon the growth of industry are so inextricably interwoven with other factors that no unraveling of causes is possible. This much is certain, however. The United States would in any case have become a great industrial nation because she possessed everything essential to such development: a vast wealth of diversified resources, including rich supplies of those fundamentals of industrialism, coal and iron ore; three million square miles of territory free from obstacles to internal trade, thus permitting a widespread division of labor within the country; an active, aggressive, and intelligent population; political and social institutions which guaranteed freedom of enterprise and initiative. Under any conditions, a nation so richly endowed is certain to become a great manufacturing nation. Protection may have hastened the development of diversified manufactures in the United States; its absence could not have prevented it.

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## *Methods of Mitigating the Tariff*

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The imposition of a tariff usually causes the domestic price of the commodity upon which the duty is levied to rise; the effect of import duties on domestic prices has been analyzed in detail in Chapter X. There are cases, however, in which the imposition of a duty will not cause the price of the protected article to rise, e.g., where the foreigner pays the tax, or where the article is already being exported. But the combination of circumstances whereby the foreign producer is compelled to bear the duty is so unusual that it is rarely found; and we find that tariffs are infrequently levied on articles of export. If, in fact, the purpose of a duty is to protect home industry, and if the duty does not succeed in raising the domestic price of the taxed article, additional protection will soon be demanded—and will probably be obtained. Even duties imposed for purposes of revenue will in most cases result in higher domestic prices.

Price increases which result from import duties are reflected, directly and indirectly, in the production costs of domestic industries. Raw materials may be included among the taxed goods, and many articles of general consumption undoubtedly will be; the consequent rise in living costs will bring from workingmen demands for wage increases. As long as domestic producers sell their products on the domestic market, they suffer no serious harm as a result of the higher costs, because the tariff protects them from the competition of foreign goods whose costs of production are not affected by the duties. These higher costs are, however, a serious handicap to domestic concerns which must sell in foreign markets, and are a quite unintentional and unwelcome handicap to a country's export and re-

export trade; they also penalize, undesignedly, the transit trade.

In order to prevent, or to repair, the damage which import duties inflict upon exporting, reexporting, and transit interests, governments have devised arrangements whereby various imports are, under certain conditions, exempted from duties, and foreign goods are granted freedom of movement within the country. These regulations include the direct exemption from, or reduction of, import duties, drawbacks, bonded warehouses, free ports and zones, temporary importation, manufacture in bond, and special regulations for transit and transshipment. All these arrangements differ from tariff reductions in that they are not intended to affect the protective function of tariffs. Nevertheless, the borderline between those measures devised merely to mitigate the severities of tariffs for the export and the transit trade, without interfering with protection, and actual reductions in protection is, in practice, never clearly drawn.

#### EXEMPTION FROM AND REDUCTION OF DUTIES

Goods which might normally be subject to duties upon importation are under certain circumstances admitted free of duty. Exemption from duties is frequently granted to certain dutiable goods which have been exported and are later returned in an unaltered form. It is fairly common in the case of goods which have been in a foreign market, fair, or exhibition and for containers and packing materials used for the exportation of domestic products. The American tariff law provides for the free reimportation of empty containers and coverings of various kinds exported filled with American products, or exported empty and returned filled with foreign products, articles exported for repairs, and articles exported for exhibition at any exposition, fair, or conference held in a foreign country. Articles exported for repairs must, upon reimportation, pay a duty upon the value of the repairs at the rate at which the article itself would be subject if imported. Articles exported for exhibition purposes must be properly registered before exportation and must be reimported within a certain stipulated time in order to qualify for exemption from duties. The exemption from duties also applies to articles of foreign production, provided they have once paid the duty in the United States and no drawback has been allowed on them. Exemption is also granted on the wearing apparel, personal



### 334 International Trade and Commercial Policy

and household effects of residents of the United States returning from foreign countries, if the goods were taken out of the United States by the residents demanding exemption. No more than one hundred dollars worth of goods acquired abroad by residents of the United States may, however, be admitted free of duty upon their return. Under the American Tariff Act of 1930, a duty must be paid upon the reimportation of American products, once they have been exported; this duty shall be equal to any internal tax imposed on such articles if no internal tax has been paid, or if the internal tax has been paid but has been refunded by drawbacks.

All British goods may be brought back into the United Kingdom under a bill of store if they are reimported within five years of their exportation and if the British origin of the goods is proved; but any drawback received upon exportation must be returned. Foreign goods, on the other hand, are liable, upon reimportation, for the same duties as upon their first importation. Where the reimports into the United Kingdom have undergone processing abroad, but their form or character has not been changed, the duty is chargeable only upon the increment in their value which is due to the processing abroad.

Another category of goods which in most countries usually enjoy exemption from duties are samples without value. In order to provide uniform international treatment for samples without value, the Economic Committee of the League of Nations drafted a report which suggested that "samples of goods of all kinds shall be exempted from customs duty on importation, with the exception, however, of those which form the subject of import prohibitions or restrictions, state monopolies, or excise, provided they have no commercial value, that is to say, that they can only be used for soliciting orders, for demonstrations, experiments, or analyses."<sup>1</sup>

Imports of machinery and materials for use in the establishment or development of a national industry have been exempted from the payment of duties by many countries. The United Kingdom, for example, exempts from import duties goods consigned directly to a "registered shipbuilding yard" for use in the building, repairing, or refitting of ships, in accordance with conditions laid down by the customs authorities. Germany before World War II provided duty

<sup>1</sup> Quoted by O. Paranagua, *Tariff Policy*, p. 126.

exemption for shipbuilding materials, while Portugal exempted from duties machinery and materials used in the cork industry.

Many countries grant reductions in import duties on certain goods used in manufactures. Thus, in Switzerland, edible olive oil is taxed 10 francs per 100 kilos, while olive oil for industrial purposes is taxed only one franc per 100 kilos. Great Britain permits apples to be imported duty-free, if consigned direct to a cider factory, under conditions assuring that the apples shall be made into cider in that factory, while other apples pay, under the Ottawa Agreements, a duty of 4s. 6d. per hundredweight.<sup>2</sup>

The cases described in this section should not be confused with the "free list" of the tariffs of many countries. These "free lists" enumerate articles which shall be admitted duty-free regardless of whether they are reimports, or the uses to which they may be put. For example, unmanufactured cork wood or bark is on the free list of the American tariff and is therefore admitted duty-free under all conditions; on the other hand, live cattle must pay a duty of \$0.025 or \$0.03 a pound—depending upon whether they weigh under or over 700 pounds—unless they are native and are being reimported from exhibition at some foreign fair; in the latter case they are admitted free of duty.

### DRAWBACKS

A drawback is a refund, in whole or in part, either of customs duties paid on imported merchandise which is subsequently reexported, or of internal excise taxes on goods exported. This restitution of taxes may be made upon articles reexported in the same condition as they were when imported, or it may be applied to raw materials or semi-manufactured goods when they are reexported in a more advanced state of manufacture. Although drawbacks of the former type were earlier very common, the development of the bonded warehouse system, more efficient and more lenient tariff regulation of the transit trade, and better means of communication and transportation have made them less important today. The latter type of drawback, on the other hand, has become more and more important in modern commercial policy.

Although drawbacks are paid, as a rule, only upon the act of ex-

<sup>2</sup> Cases cited by Paranagua, *op. cit.*, pp. 126-127.

### 336 International Trade and Commercial Policy

portation, there are a few instances where they are paid upon goods utilized in the manufacture of articles destined for domestic use. The Canadian tariff, by way of illustration, allows drawbacks to be paid on silk which is to be used for lining caps and other articles destined for sale in the Canadian market.<sup>8</sup> The purpose of such a refund is to relieve domestic producers of the burden of import duties upon raw materials which enter into the manufacture of goods that have to compete with imported goods. Although the same result can be accomplished by raising the duties on imports of the finished articles, i.e., by imposing compensating duties, such duty-increases will antagonize consumers by forcing up the prices of the finished articles. Drawbacks for such purposes are, however, exceptional; the usual drawback is the one paid upon exportation.

In the United States, drawbacks are paid on (1) the exportation of all articles manufactured or produced with the use of imported goods, except flour or by-products produced from imported wheat; (2) imports that are reexported in their original state within a period of three years; and (3) products that involve a refund of the internal tax on the alcohol which enters into the manufacture of exported flavoring extracts, toilet preparations, perfumery, and medicines. The British drawback system differs from the American system in that goods entitled to the drawback are specifically designated in the tariff. Drawbacks of duties levied under the Import Duties Act of 1932 are allowed on the exportation, or shipment as stores, of certain classes of manufactures of cotton, wool, linen, or jute. Drawbacks are also paid on the exportation of all Key Industry goods and most articles chargeable with duties under Part 7 of the British Tariff, as well as those chargeable with excise taxes. France grants drawbacks only on a restricted number of goods, e.g., cotton yarns employed in the manufacture of certain tissues and salt used in preserving fish, meat, butter, etc.

The drawback system is essentially a compromise between two conflicting aims: the desire to tax imports heavily, and the desire to maintain the international competitive power of domestic industry. But no system of drawbacks can ever quite offset the effects of a tariff. In the first place, the full amount of the duty is frequently not refunded. In both the United States and Canada, for instance, the

<sup>8</sup> See J. Anton de Haas, *The Practice of Foreign Trade*, p. 88.

refund rate is 99 per cent of the import duty, the remaining one per cent being retained by the government to meet the costs of administration. In other countries, however, a full refund is granted; refunds are granted in full, for example, in Belgium and on many goods in Great Britain. A second source of loss to the importer is the forfeiture of interest on the funds which he must surrender as duty when the goods are imported. The importer is unable to avoid such a loss even though the full amount of the duty is eventually refunded; he is compelled to pay the duty when the goods are imported, but he does not receive the drawback until at least thirty days after reexportation—in no case until a landing certificate has been filed.<sup>4</sup> The net result of this delay in receiving the drawback is that the importer foregoes the use of his funds during the period from the payment of the duty to the receipt of the drawback; he is thus deprived of the opportunity of earning interest on these funds for this period.

The most important cost of the drawback system, however, arises from the amount of delay and red tape which the administration of the system involves. Yet the necessity of making certain that drawbacks are paid only on goods actually imported, and that they do not exceed the amount of duty paid, makes impossible the elimination of this red tape. The difficulty of administration is slight where the goods exported are in their original form; then it is only necessary to prove that the goods on which exporters are demanding a drawback are the identical goods previously imported. Frequently, such identity may be proved by means of official marks or stamps. But the situation becomes more involved when the imported article undergoes change, or is merged with many complementary materials into a finished article, before it is reexported. In such cases, the manufacturer must furnish proof of the quantities of imported materials which enter into the finished products to be exported, as well as the amount of the duties originally paid on these materials. The difficulty of ascertaining these facts means that arrangements must be made with the customs administration before the manufacture of the articles to be exported can be undertaken, in order that the

<sup>4</sup> The landing certificate is a document signed by a foreign customs official, or by the captain of the ship transporting the exports, which testifies to the actual landing of the goods on a foreign shore.

### 338 International Trade and Commercial Policy

government officials may determine beforehand the quantities of the imported materials that enter into the finished articles; thus the factory in which the goods are made must pay for constant government supervision. The delay, red tape, and expense of the procedure and the fear that governmental supervision and inspection may disclose trade secrets have discouraged many firms legally entitled to drawbacks from applying for them. The United States Tariff Commission itself has declared that, "The privilege is so hedged about with exacting and intricate regulations that the amount of the drawback does not pay for the labor and cost of collecting it."

It is customary to fix a time limit within which the drawback will be paid. In many countries, including the United States and Australia, this limit is three years.

A drawback differs from an export bounty in its purpose. The purpose of an export bounty is to enable an exporter to sell a product abroad at a lower price than that charged in the home market; the purpose of a drawback is merely to exempt from the payment of customs duties imported goods which are not intended for home consumption. However, export bounties may actually be paid under the guise of drawbacks. Drawback payments have, on occasion, been made excessive in amount for the definite purpose of granting bounties without openly acknowledging that the payments were, in substance, bounties. But the degeneration of drawbacks into export bounties may take place all unknowingly, unless the system is efficiently controlled. When a raw material is imported, worked up, and exported in finished form, an official ratio between the raw material and the finished product must be established in order to determine the amount of the drawback to be paid upon the exportation of a given quantity of the finished product. If a given amount of raw material produces more of the finished product than the official calculations allow for, the drawback will be greater, in proportion, than the duty paid. This will amount to granting a concealed bounty to exporters; sales abroad will be encouraged, as compared with sales at home, and the domestic price of the finished product will tend to exceed its price in foreign markets.

An illustration of the metamorphosis of a drawback into an export bounty is furnished by the German beet-sugar industry. The Ger-

man government levied upon sugar beets an excise tax, to be collected at the time the beets were delivered to the factory; this tax was based upon the estimated sugar content of the beets. At first, the tax was levied upon the assumption that 18 pounds of beets would yield one pound of sugar; accordingly, for every pound of sugar exported, there was refunded as a drawback a sum of money equivalent to the tax collected upon 18 pounds of beets. As long as this assumption proved correct, the drawback remained only a drawback. But, gradually, the quality of the beets improved, and the methods of extraction became more efficient, so that the production of one pound of sugar required only 10 pounds of beets, or even less. This resulted in a substantial export bounty on sugar so long as the excise tax and the drawback allowance remained unchanged. Sugar consequently became cheaper in countries which imported it than in Germany and other producing countries which granted a bounty upon sugar exports.<sup>5</sup>

#### IMPROVEMENT TRADE (TEMPORARY ADMISSION)

Another arrangement for eliminating the payment of import duties upon goods devoted to certain uses is the improvement trade. Under an *active* improvement trade, foreign goods are permitted temporary entry into a customs area duty-free, if they are not to be consumed within the area but are instead to undergo transformation, supplementary treatment, or repair and then be reexported in their finished form. This temporary free admission is granted mainly to raw materials or semi-manufactured goods. The importer is required, under this arrangement, either to give a bond, equal to the duty on the goods, and reexport the goods within the period fixed by the customs regulations, or to pay the duties. The object of temporary importation is the same as that of drawbacks, viz., to allow domestic industries to use foreign supplies without subjecting them to the handicap of paying import duties on these supplies, and to free them from the necessity of using high-priced domestic supplies; the tariff is not to impair the ability of domestic producers to compete with foreign producers in foreign markets. Temporary importation has one advantage over drawbacks: it does not require the

<sup>5</sup> See de Haas, *op. cit.*, pp. 92-93.

## 340 International Trade and Commercial Policy

importer to pay any duty, and thus does not deprive him of the use of his funds during the period from the importation of the goods to their reexportation.<sup>6</sup>

Like drawbacks, however, the improvement trade presents administrative difficulties. When goods are imported free of duty, the customs officials must make sure that they are reexported again within the legal time; they must also see to it that goods which are legally dutiable do not escape the payment of duties. Where expor-

<sup>6</sup>The United States Tariff Act of 1930 provides that:

"The following articles, when not imported for sale or for sale on approval, may be admitted into the United States under such rules and regulations as the Secretary of the Treasury may prescribe, without the payment of duty, under bond for their exportation within six months from the date of importation, which period may, in the discretion of the Secretary of the Treasury (whether such articles are imported before or after this section becomes effective), be extended upon application, for a further period not to exceed six months:

"(1) Machinery or other articles to be altered or repaired;

"(2) Models of women's wearing apparel imported by manufacturers for use solely as models in their own establishment, and not for sale;

"(3) Samples solely for use in taking orders for merchandise or for examination with a view of reproduction;

"(4) Articles intended solely for experimental purposes, and upon satisfactory proof to the Secretary that any such article has been destroyed because of its use for experimental purposes such bond may be canceled without the payment of duty;

"(5) Automobiles, motorcycles, bicycles, airplanes, airships, balloons, motor-boats, racing shells, and similar vehicles and craft, teams and saddle horses, all of which are brought temporarily into the United States by non-residents for touring purposes or for purposes of taking part in races or other specific contests;

"(6) Locomotives, cars and coaches, and repair equipment belonging to railroads brought temporarily into the United States for the purpose of clearing obstructions, fighting fires, or making emergency repairs on lines the property of railroads within the United States;

"(7) Containers for compressed gases which comply with the laws and regulations for the transportation of such containers in the United States;

"(8) Articles imported by illustrators and photographers for use solely as models in their own establishments, in the illustrating of catalogues, pamphlets or advertising matter."

Paragraph 1607 of this act also provides for the free temporary importation of "animals and poultry brought into the United States for a period not exceeding six months, for the purpose of breeding, exhibition, or competition for prizes offered by any agricultural, polo, or racing association; but a bond shall be given in accordance with regulations prescribed by the Secretary of the Treasury; . . ."

tation takes place in accordance with the principle of identity, the goods imported are marked by the customs officers with official plombs or seals, so that their identity may be readily established upon exportation. Where reexportation takes place in accordance with the principle of equivalence, however, the goods imported lose their identity upon importation; an *equivalent quantity* must therefore be reexported, and the equivalence of the imports and the exports is checked by the issuance of certificates. Obviously, the improvement trade, like the drawback, involves a certain amount of red tape and considerable governmental supervision of the goods enjoying the privilege.

There can be no just complaint against the improvement trade by domestic producers of raw materials and semi-manufactured goods where the producers of finished goods would be unable to develop an export business if they had to pay duties on imported materials or purchase high-priced domestically produced materials. But it sometimes happens that domestic producers of materials do lose sales which they would otherwise make to domestic producers of finished goods, who buy duty-free imported materials to be sold in finished form abroad. Consequently, such exemptions are at times a source of friction among the parties concerned.

There is also a *passive* improvement trade. Home-produced goods which have been exported for the purpose of being processed abroad are permitted to be imported in their finished form free of duty, except for a duty on the increment in value that results from the processing. A passive improvement trade to one country is an active improvement trade to the country in which the processing of the goods takes place.

Under the protectionist spirit of today, nations have been somewhat more liberal in their regulations affecting their active improvement trade than in those affecting their passive improvement trade. But hindrances to the passive improvement trade of one nation are hindrances to the active improvement trade of another, and they easily lead to retaliation by the second nation, which may restrict its own passive improvement trade—the active improvement trade of the former. When situations of this sort develop, the only way to revive the improvement trade is through the granting of reciprocal concessions.



**BONDED WAREHOUSES**

Another, and a somewhat more efficient, device for removing the burden of import duties, where the imported goods are to be re-exported, or are to undergo manufacture and be exported in a different form, is the bonded warehouse. In countries which employ the bonded warehouse system, articles may be imported and deposited in a bonded warehouse without payment of duty. From the warehouse the goods may be exported, upon the payment of storage charges but without the payment of import duties or taxes; or they may be admitted into the country for consumption upon the payment of storage dues and import duties or taxes. The bonded warehouse is thus not only a means of reconciling import duties and a vigorous reexport trade; it is, in addition, a credit system whereby the government extends the time for the payment of duties or taxes upon goods, in the meantime retaining possession of the goods as security. The postponement of the payment of duties, under the bonded warehouse system, is an important advantage to manufacturers and importers, because the immediate payment of duties, or internal taxes, would frequently involve the unremunerative, temporary locking-up of sizable amounts of working capital. Furthermore, the importer, or manufacturer, has access to the goods at all times and may gain possession of them by paying the duties, excise taxes, and storage charges, if they are to be sold at home, or by paying simply the storage charges, if they are to be sold abroad.<sup>7</sup>

Bonded warehouses may be maintained by the government or port authority, or they may be privately owned and operated. In France, Germany, Holland, and many other countries of Europe and South America, publicly maintained warehouses are found, or were found before the war. In the United States, the Federal government owns or leases warehouses, but these are used only for merchandise undergoing appraisalment, or for unclaimed or seized imports.

<sup>7</sup> Bonded warehouses may also be used for the storage of strictly domestic products upon which excise taxes are levied. By storing the finished product, in bonded warehouses, the manufacturer may delay payment of the excise tax until the goods are withdrawn for domestic sale. If the goods are withdrawn from bond for export, the tax need not be paid. The products for which most frequent use of this privilege is made are distilled spirits and tobacco.

Where government storage facilities are inadequate for the storage of all the goods requiring accommodation, privately owned warehouses are permitted to operate—but only under government supervision. The “publicly bonded warehouses” in the United States are privately owned, but any importer is entitled to use them upon the payment of the usual charges. Privately owned warehouses are also found in France, Great Britain, Holland, and many countries, but they are not found in Germany.

In addition to the government warehouses and the private bonded warehouses used for the general storage of goods—in France, both are known as the *entrepôt réel*—there are the importers’ bonded warehouses which contain exclusively the goods of the owners of the warehouses. These are called in France *entrepôts fictifs*. In the *entrepôt réel*, the goods are withdrawn from the control of the owner, with certain exceptions—in the German public warehouses, for example, sorting, cleaning, and repacking of the goods are allowed. In the *entrepôt fictif*, on the other hand, repacking and manipulation of the commodities may take place without specific permission of the customs authorities, and frequently manufacturing may also be performed. Although inspection of the warehouse and the goods by the customs authorities is made periodically, the owner of the merchandise enjoys a greater degree of freedom in the *entrepôt fictif* than in the *entrepôt réel*. In Great Britain, packing, sorting, and manufacturing are allowed in the bonded warehouses—which are all in private hands—with the permission of the Commissioners of Customs. The United States Tariff Law authorizes the establishment in the United States of special warehouses (Class 8) for the purpose of cleaning, sorting, repacking, or otherwise changing in condition—but not manufacturing—imported goods under customs supervision.

Under some systems, the manufacture under bond of articles for export is permitted. Provision is made in the United States for the establishment of private bonded warehouses (Class 6) for the manufacture of articles for exportation, made in whole or in part of imported materials, or of materials subject to internal revenue taxes; for the storage and cleaning of imported rice intended for exportation; and for the manufacture for home consumption, or exportation,

### 344 International Trade and Commercial Policy

of cigars made wholly of tobacco imported from any one country. Class 7 warehouses may be constructed for the smelting or refining of imported ores or crude metals, for either exportation or domestic consumption. Imported goods may be transferred, free of duty, from a bonded warehouse into a bonded manufacturing warehouse; and articles manufactured in a bonded manufacturing warehouse may be transferred to a bonded warehouse at the exterior port for the sole purpose of immediate export therefrom.

The owners of a bonded warehouse must give the government security in order to protect the latter from the possible loss of duties which might result from the carelessness or dishonesty of the warehouse keeper; this security is furnished by means of a bond. In many countries additional security is demanded in the form of a bond from each individual owner of goods placed in the warehouse. But in Great Britain and Holland the owner of the goods is not required to furnish a separate bond.

In most countries, a limit is placed upon the time during which goods are allowed to remain in bonded warehouses without the payment of duties. In the United States and India this period is three years; in Germany and the Union of South Africa it is five years. In France, goods may ordinarily be stored in *entrepôts réels* for three years and in *entrepôts fictifs* for one year, except in the case of wheat, which may remain for two years. Great Britain sets no time limit for goods in bonded warehouses. Goods not withdrawn from the warehouse within the credit period are sold by the government, and the proceeds from the sale are used to defray the accrued charges, the balance, if any, being returned to the owner of the goods. When the proceeds are insufficient to pay the charges, the balance is collected upon the warehouse bond.

All bonded warehouses are under strict customs regulation and supervision. Some articles, such as perishables and explosives, are not entitled to storage. Articles accepted are under the constant control and supervision of the customs officials from the time they enter port until they are reshipped. They must be arranged according to prescribed regulations in order to facilitate inspection, permits must be secured for their reception and delivery, and strict accounts must be kept of storage transactions. When goods are manufactured in bond, supervision is strict, and regulations and penalties are in gen-

eral such that only highly standardized industries find it practicable to meet them.

Bonded warehouses are sometimes located at interior points as well as at ports. The existence of warehouses so located makes it possible to ship goods directly to interior points where they may be cleared when needed, under the direct supervision of the owner. Delays in delivery to the consuming market are less likely to occur when the goods are stored close to the market than when they must be stored at some distant port.

The bonded warehouse is found most frequently in countries which carry on a large transit trade and in which manufacturing for export is important. Thus, many are located in England and Holland, but few are found in South American countries. The prevalence of export duties in South America has also been a factor in retarding the development of bonded warehouses there. Customs administrators have striven to maximize the yield from export tariffs by insisting that slight changes in the appearance of imported goods "nationalize" the goods, and thus make them subject to export duties when they are reexported.

#### TRANSIT AND TRANSSHIPMENT

In order to encourage the reexport trade and increase the traffic of ports, shipping, and railways, the customs regulations of many countries provide exemptions from the payment of duties for dutiable imported goods in transit. Such exemptions are included in the customs regulations of the United States, Great Britain, and France. Under these transit regulations, goods whose entry into the country is not expressly prohibited may usually be entered for transportation in bond by a bonded carrier to any other port in the country for exportation, without appraisalment or the payment of duties. In order to become bonded, a carrier—i.e., a railroad, a steamship or other transportation line—must file a specified bond and give such other surety as the government may designate. The carrier is responsible for the delivery of the goods to the customs at the port of exportation within a stipulated time and in the form and quantity received at the port of entry. Imported goods, in bond or duty-paid, and products and manufactures of the United States may be transported from one port to another in the United States through con-

## 346 International Trade and Commercial Policy

tigious countries. Great Britain has special regulations for goods transhipped within the same port, and France has provisions for the removal of goods by land from one warehouse to another.

### FREE PORTS AND FREE ZONES

The highest development of the bonded-warehouse principle is found in the free port or free zone. In the older and stricter sense, a free port is a maritime commercial center whose harbor is open to the commerce of the world without customs supervision, where goods may be received, stored, and exported without the payment of customs duties. As towns developed in the Middle Ages, many of them were able to secure privileges from the feudal lords in return for loans and taxes. The most coveted of the privileges granted was that of the free city. This permitted the loading and unloading of ships, manufacturing, and the purchase and sale of goods without interference from the fiscal authorities, except for compliance with regulations governing the payment for specific services, such as storage and wharfage. When goods passed from the port into the interior of the country, however, duties had to be paid. The chief free ports in medieval Europe were Venice, Genoa, Naples, Marseilles, Lübeck, Hamburg, Bremen, Trieste, and Fiume.

As cities grew in size, certain shortcomings appeared in the administration of free ports. Fraud and smuggling became rife. But the most serious disadvantage of the free port was the existence of a customs barrier between the town and the rest of the country. In order to overcome these disadvantages, free ports were abolished by most countries, and free zones or districts were substituted for them. The free zone differs from the free port in that only a limited area of the town, not the whole town, is separated from the customs territory of the country. While the free zone offers the same trade facilities as the free port, in permitting duty-free entry, storage, and export of imported goods, it avoids the principal faults of the latter. The free zone is securely fenced in, so that the entrances may be easily guarded by customs officials; and no tariff barrier exists between the port, other than the free zone, and the remainder of the country. Most of the European cities which were earlier free ports have now established free zones; many other European cities, as

well as cities in North and South America, have also designated certain areas as free districts. In a few cases—Gibraltar, Malta, Singapore, Aden, Malacca, and Georgetown, Penang—the entire city is still included in the free zone. Free-zone areas vary in size from less than an acre to two or three thousand acres.

Free zones, like drawbacks and bonded warehouses, are establishments designed to stimulate the reexport trade. They possess all the advantages of the other two systems, and, at the same time, avoid many of their disadvantages. No capital must be tied up temporarily in customs duties, as in the case of drawbacks, nor is it necessary to undergo the expense, delay, and red tape which are involved in government supervision—unavoidable features of both drawbacks and bonded warehouses. Goods consigned to the free port may be landed there, sorted, graded, repacked, processed, and reexported, without payment of duties and without any delay caused by customs supervision. Skins and furs can be looked over, some can be chosen for entry, and the rest can be sorted and shipped to other countries; in American free ports bananas from Central America can undergo transshipment to Canada. Thus, by fostering the reexport trade, a free port tends to increase the business of a country's merchant marine and to create jobs for domestic labor. It has also been argued that free ports in the United States would be advantageous because they would tend to reduce freight charges; fewer ships would have to return to Europe in ballast, and a larger proportion of imports from South America and other overseas sources could be shipped directly to the United States, instead of being transported circuitously by way of Europe—for transshipment cargoes would be available here for outbound vessels.

In some free ports, manufacturing for export is permitted. There would be little point to manufacturing for *domestic* consumption in a free zone, because the goods must in any case pay the duty as soon as they cross the customs frontier; and, usually, duties are higher on finished goods than they are on raw materials or semi-processed goods. But, when the manufactured goods are to be exported, raw and semi-manufactured materials can be assembled from every corner of the globe without delay or customs charges, and worked up for export by domestic labor. Ores can be refined,

## 348 International Trade and Commercial Policy

wheat milled, liquor bottled, coffee hulled and roasted. A free port also facilitates the importation of products which are to be mixed with domestic products and then exported.

### FREE PORTS IN THE UNITED STATES

For many years prior to 1934, the establishment of free ports—today the term “free port” is used loosely to refer to a free zone—in the United States had been urged. It was argued that free port privileges would foster as phenomenal a development of certain American ports as they had of ports like Hamburg and Bremen, to which large steamships carry products from overseas to be re-shipped in smaller coastal steamers for distribution to the many Baltic ports, which lack the long-distance shipping connections of the large north German cities. The development of a large reexport trade, it was urged, would also mean an extension of the services of banks, insurance companies, and various functional middlemen.

Some individuals, however, pointed to the unfavorable geographical position of American cities as reshipment centers. They explained that there would seem to be little point to landing goods in any American free port for transshipment to other American cities, for goods destined for any consuming market in the United States would, in any case, have to enter the American customs territory. Since Canadian ports are well served by steamships, little reexport trade to our northern neighbor could be anticipated. And the great distance from North American to South American ports makes it easier to ship goods from Europe direct to South America than via North America. It was pointed out further that existing regulations providing drawbacks, bonded warehouses, and manufacture in bond were more liberal in the United States than in most European countries and already made possible entry for reshipment under very favorable conditions. Finally, doubts were expressed that American free ports would develop into manufacturing centers for goods intended for export. Where only small branch factories were set up in free ports, the chief American competitive advantage—large-scale, standardized production—would be forfeited; where manufacturing for export constitutes the major portion of the total production, on the other hand, the tendency has been in recent decades to erect branch factories abroad, which operate inside

foreign tariff walls and employ foreign labor at wages considerably below the American level.

Despite the doubts which the critics raised concerning the practicability of establishing free ports in the United States, the interests which for many years had been advocating such zones were at last rewarded by the enactment in June, 1934, of the so-called Cellar Bill, which provides for the establishment, operation, and maintenance of foreign trade zones in, or adjacent to, ports of entry in the United States. Foreign and domestic merchandise of every description—except such as is prohibited by law—may, without being subject to the customs laws of the United States, be brought into such zones, and may be stored, broken up, repacked, assembled, distributed, sorted, graded, cleaned, mixed, or otherwise manipulated, and stored. But it may not be manufactured or exhibited. When the merchandise is sent from a free zone into customs territory, it becomes subject to the laws and regulations of the United States affecting imported merchandise.

A board consisting of the Secretary of Commerce as Chairman, the Secretary of the Treasury, and the Secretary of War was created to carry out the provisions of the Act. The Board is given the authority to grant to corporations the privilege of establishing, operating, and maintaining free zones, to prescribe rules and regulations governing their operation, to see that rates and charges for all services and privileges within the zone are fair and reasonable, and to revoke the grant after due notice, in the event of repeated, willful violations of any of the provisions of the Act. Both public and private corporations may apply for permission to establish zones, but, in making grants, the Board is obligated to give preference to public corporations. Each port of entry is entitled to at least one zone. The initiative in the establishment of a zone must come from the locality, and all risks and costs of operation must be borne by the corporation.

At the end of 1940 two American ports had established free zones—New York and Mobile. Applications for permits to establish and operate zones in several other ports of entry—including San Francisco, Los Angeles, Seattle, San Juan, and Jersey City—were at that time pending before the Board. The first American Foreign-Trade Zone, located at Stapleton, Staten Island, New York, embraces a



### 350 International Trade and Commercial Policy

land and water area of 96 acres and includes five piers. It went into operation on February 1, 1937. During the remainder of 1937 it handled 10,586 tons of merchandise valued at \$1,174,293, which increased in 1939 to 100,845 tons valued at \$39,082,240. In 1938 the zone was transferred from municipal to private operation. A large part of the Foreign-Trade Zone was taken over by the United States Government for the duration of the second World War.

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## ***Indirect Protectionism. Protective Excise Taxes***

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### INDIRECT PROTECTIONISM

In the decades preceding the first World War, growing protectionism was evidenced primarily by the expansion and heightening of tariffs. The postwar decades witnessed an acceleration of protectionism, in which tariffs still played a big role, but in which resort was also had on an increasing scale to more direct restrictions upon imports—prohibitions, quotas, exchange control, clearing and payments agreements. But the true scope of protectionism, in either period, is not revealed by these more direct forms of trade restriction alone. Side by side with this structure of visible trade restrictions, each of which is a definite legislative event, which assumes the effectiveness of law only after weeks and months of public discussion, there has grown up a second tariff structure, a structure constituted largely of administrative controls over imports, which usually come into being without any widespread discussion in legislative halls, in the press, or on the street. These restrictions are found in the administrative provisions of tariff acts, in customs regulations, in the decisions of customs courts, in the regulations of various government bureaus, departments, and other administrative agencies, and in certain extra-legal restrictions on the import trade, such as consumers' boycotts and the refusal of union labor to handle imported goods. This heterogeneous and indefinable group of import restrictions has come to be known as "administrative protectionism," "indirect protectionism," or the "invisible tariff."<sup>1</sup>

<sup>1</sup> The most recent and most comprehensive work on indirect protectionism in the United States is Percy W. Bidwell's *The Invisible Tariff*. I am heavily indebted to Dr. Bidwell's work for much of the material in the present chapter.

## 352 International Trade and Commercial Policy

Indirect protectionism is a concept difficult to define. On the negative side, it excludes all direct forms of import restriction: tariffs, prohibitions, quotas, exchange control, and clearing agreements; on the positive side, it consists of a host of clandestine and underhanded specific protective devices for circumventing every kind of international commercial obligation and agreement. Outstanding among the numerous instrumentalities of this indirect protection are veterinary regulations, sanitary regulations of food products, marks-of-origin requirements, the protection of patents, arbitrary and discriminatory tariff classifications, arbitrary customs valuations, oppressive customs formalities, exclusion measures connected with the letting of public contracts, and preferential railway rates.

The origins of the invisible tariff may be traced to two quite different sources: (1) the increasing regulation of industry and commerce through the police powers of the modern state, and the perfection of administrative instruments and devices which enable the state to undertake assignments which it would not have dared attempt a few decades ago; and (2) the growth of the protectionist spirit. In the economic sphere, the past half century has been characterized by a steady extension of government regulation of domestic business, a trend which reflects a dilution of the popular fear of state intervention and a growing hope that the public welfare may be enhanced by a judicious modification of the system which grants free play to economic forces. But each new extension of government regulation and supervision over domestic industry and trade has necessitated a corresponding extension of controls over imports. Controls over the trade in alcoholic liquors and narcotics and pure food and drug legislation obviously cannot be effective unless they are extended to imports. It does little good to subject domestic plants and animals to rigid inspection and controls, as a means of combatting disease and parasites, if at the same time imports of foreign plants and animals which may be infected with the diseases being combatted at home are permitted. Domestic inventors will derive little benefit from their inventions, even if the inventions are patented, unless protection is afforded them against the importation of foreign goods produced by the patented processes. All these controls represent a proper exercise of the police power of the state,

and their extension to imports is merely a necessary enlargement of its scope, if effective regulation is to be ensured.

There can be no dispute about the right of any sovereign state to put into effect whatever measures appear, in its judgment, necessary to protect the welfare of its citizens. Yet, as one writer has stated, "Extra-tariff controls of imports are objects of suspicion. In every customs regulation, every sanitary restriction on importation of animals and plants, it is possible that there is concealed a measure of economic protection."<sup>2</sup> All too frequently, measures originally designed to give biological protection to domestic plant and animal life, or to protect domestic producers from unfair competitive practices on the part of foreign producers, have been used to shield domestic interests from *any* foreign competition whatsoever. Moreover, such administrative measures are often used as tools of discrimination—to exclude the products of one country, while similar products from other countries are permitted entry. Although discrimination of this sort is indefensible as a publicly acknowledged policy, and few countries would care to defend it, it may be carried on for a considerable period under the guise of a legitimate measure of non-economic protection.

In explaining the genesis of administrative protection before the first World War, Josef Grunzel calls attention to its use by free-trade countries as a means of putting protection into force without appearing to abandon the traditional policy of free trade.<sup>3</sup> "In England," he avers, "the free-trade doctrine had become so firmly established on account of its theoretical background and its tactical advantages, that in the course of time corrections which had become necessary could be carried out only in the application of the principle and not by modifying the principle itself."<sup>4</sup> Hungary, bound by its customs union with Austria to grant free trade to the latter, its most formidable competitor, even though it was an independent economic organization with its own legislation and its own administration, early developed indirect protection as a substitute for the tariff protection excluded by the agreement. Not only has the in-

<sup>2</sup> Percy W. Bidwell, *The Invisible Tariff: A Study of the Control of Imports into the United States*, Council on Foreign Relations, Inc., p. 3.

<sup>3</sup> *Economic Protectionism*, Carnegie Endowment for International Peace, Oxford University Press, pp. 179-180.

<sup>4</sup> *Ibid.*, p. 180.

## 354 International Trade and Commercial Policy

visible tariff been employed to effectuate protection and at the same time get around treaty obligations and avoid retaliative measures by foreign countries; it has also proved to be an efficient method of establishing, or increasing, protection without giving rise to the wranglings between political parties and industrial and commercial interests which new tariff laws always evoke. The attacks by the Democrats on the Republican Tariff Act of 1930 during the American presidential campaign of 1932 and the dissatisfaction of, first, domestic agricultural interests and, later, domestic manufacturing interests with French and German tariff acts before the first World War show how embarrassing to the party in power new tariff legislation can be. How much happier is the political life of the government which can satisfy the demands of vocal economic interests and at the same time keep the rest of the community in blissful ignorance of the facts and costs of surrender to these interests!

The intensification of protection in the period since the 1870's has itself contributed to the growth of the invisible tariff. Each rise in tariff barriers put an increasing premium on smuggling, undervaluation, and other evasions. Consequently, greater attention had to be given to plugging the holes through which illegal imports were entering and to insuring that goods entering legally paid the full duties to which they were subject. Each tariff revision also brought a more minute classification of dutiable goods, which in turn gave rise to innumerable disputes over the classification of specific goods. The inevitable result has been to make customs administration, of necessity, a highly complicated business. The number of customs officials has been multiplied, and the responsibilities of these officials have become more and more burdensome, as legislation concerning customs formalities and procedure, administrative regulations, and court decisions have woven such a confusing legal maze around importing that only a group of highly specialized customs lawyers and brokers can safely find their way through it. In many instances, regulations and court decisions appear to have been devised for the sole purpose of making importing as difficult as possible. Although it is probably true that the purpose of customs law is not to obstruct imports, nevertheless, as one writer says, "given the complex character of import trade and the corresponding complexities of our visible tariff, any system of customs laws, no

matter how neutral in intent and in administration, inevitably interposes added obstacles to the entry of foreign merchandise.”<sup>5</sup> The costs of hiring customs lawyers and brokers, the premiums on bonds which must frequently be posted, the litigation to which importers are at times forced to resort in order to protect their rights, the harassments to which importers are sometimes subjected by domestic interests under the privileges granted them under tariff laws and customs regulations, and the delays in appraisement all go to make importing an expensive and risky business.

All in all, it must be concluded that indirect protection has proved to be a very effective method of bestowing protection where none is normally implied, or of granting a higher degree of protection than the schedules of the published tariffs appear to grant. Administrative measures are today more comprehensive than the visible tariff, for they affect goods on the free list as well as those which are subject to duty; they can be introduced more quickly and more quietly than new import duties, because they do not have to wait upon legislative discussion and decision; and they are more effective than the visible tariff, because they make use of quotas and prohibitions, as well as duties. Indirect protection is especially troublesome to traders, because it is always appearing in new forms not covered by trade agreements; consequently, there can be no certainty that any new commercial agreement will keep the channels of trade clear for long.

The exact nature of indirect protection may best be explained by illustrations of some of the more common practices which fall within this classification.

#### OPPRESSIVE CUSTOMS FORMALITIES AND ADMINISTRATION

Attention has already been called to the fact that the increasing variety of imports and the growing complexity of customs laws have made customs administration so technical and intricate that it is hardly intelligible to the layman. The consequent necessity of hiring specialized customs brokers and customs lawyers increases the costs of importing, and thus tends to discourage it. The customs formalities incident to appraisement, the expenses of filing bonds, and the delays, and sometimes unsatisfactory results, of customs decisions

<sup>5</sup> Bidwell, *op. cit.*, p. 6.

## 356 International Trade and Commercial Policy

all constitute obstacles to importing, even though the administration may be carried out in the best of faith. But they may become insidious media for increasing protection—without appearing to be—when it is desired to provide protection in excess of the amount granted in the tariff laws. Duties on goods sent by post may be made payable at the frontier, instead of at the office of delivery—an obvious, and frequently costly, nuisance. Notices of changes in rates of duties, quotas, tariff classifications, and regulations governing import procedure may be difficult to obtain, so that importers can never be certain what the rates and customs formalities actually are—a situation which offers little encouragement to importing. The investigation of claims may be made expensive, and may be permitted to drag on for a long time, while high “supplementary” fees are charged for examining the goods.

Importers in the United States have on occasion complained of administrative delays. A representative of the importers testified at hearings before the Senate Finance Committee in 1938, “Delays in returning invoices by the appraiser to the collector in the past few years have been so frequent and have caused such disturbance to the business of the importer as to require that there be some time limit specified in the law within which such returns must be made. Returns of invoices have been withheld for as long a period as three years, and it is not uncommon for such returns to be delayed for six or eight months or a year.”<sup>6</sup> During this period of delay, the importer cannot be sure of the amount of duty which he will be compelled to pay, and must either hold up the sale of the goods or sell at prices which may turn out to be too low to cover the duty and afford him a sufficient profit. American customs officials have denied, however, that the return of invoices after appraisalment has been unreasonably delayed; they have stated that over 90 per cent of all appraisements are completed within 20 days after the merchandise is entered.

Another cause of complaint by American importers has been the alleged abuse by domestic manufacturers, producers, and wholesalers of their rights to protest against improper appraisalment or classification, for the sole purpose of harassing the importer. Until

<sup>6</sup> *Ibid.*, p. 34.

1938, American producers or wholesalers might complain to the Secretary of the Treasury, if they believed that imported goods were being appraised at too low a value. If the Secretary failed to find the complaint justified, and refused to bring suit for reappraisal in the Customs Court, the manufacturer or producer might file an appeal for reappraisal on his own account. Similar protests could be made against the classification of imported merchandise, if it was believed that the proper rate was not being assessed. A final appeal could be made from the decision of the Customs Court to the Court of Customs and Patent Appeal. But, once appeal was made from the Secretary's decision, the final ascertainment of duties was suspended on all merchandise of the protested class, imported more than 30 days after the Secretary's decision, until the final decision of the Customs Court. This final decision was not forthcoming, on the average, until a year and a half later; in some cases, the delay amounted to as much as three and a half years. During this period importers were left in doubt about their liability for duties. It can thus be seen that the law invited domestic manufacturers, producers, and wholesalers who were in competition with domestic importers to "initiate proceedings which may not be well founded and which may be pursued without real hope of ultimate success in the knowledge that a barrier may be maintained against foreign competition for as long as the proceedings may be kept alive."<sup>7</sup> Fortunately, the law was reformed in 1938, so that court decisions are no longer retroactive. Now, importers may continue to bring in protested goods at the rates assessed by the customs officials until the court decides otherwise.

The degree of protection afforded any commodity, or group of commodities, may also be increased by the expedient of merely altering the method of valuation. American tariff law provides several alternative methods of valuation for the purpose of levying duties. Wherever possible, the appraiser must set the value of imported merchandise at "foreign value" or "export value," whichever is higher. "Foreign value" is defined as the general market price in the country of export at the time of exportation; "export value" is the foreign value "for exportation to the United States." For those

<sup>7</sup> *Ibid.*, pp. 39-43.



## 358 International Trade and Commercial Policy

imports for which neither the actual foreign value nor the export value can be ascertained, the appraiser is instructed to construct a theoretical foreign value known as the "United States value." United States value is found by taking the market price of the imported goods, or similar merchandise, in the principal market of the United States, and deducting from this price freight, insurance, duty, commissions, and profits, in order to arrive at the probable foreign value. The United States value almost always turns out to be higher than the foreign value would have been, had it been ascertainable, because the law sets the maximum allowance for commissions at only six per cent and for profits at only eight per cent, in each case well below the average.

The persistent agitation of certain protected American interests for the appraisalment of imported goods for duty assessment purposes upon the basis of United States value, instead of foreign or export value, is thus in reality a plea for higher protection—an increase which would not appear in the tariff schedules. Although valuation on the basis of the price in the American market has never been accepted as the basic principle of assessment, it has been applied in a few instances. Under the flexible provisions of the Tariff Acts of 1922 and 1930, the President has substituted American value for foreign value as the base for duty assessment for certain goods, including cotton rugs, prism binoculars, rubber-soled boots and shoes, rubber boots, shoes, and overshoes, clams, and knit gloves. The most important group of goods to which American valuation has been applied is coal-tar products, a concession granted by Congress after the first World War, when a young industry was apprehensive of a resumption of German exports, promoted by exchange depreciation. Where coal-tar imports are comparable to, or competitive with, American products, the American selling price is to apply; if there is no American production of comparable, or competitive, products, the duty is to be based upon the United States value.

Where the dutiable value is assessed arbitrarily by customs officials, as it is in Argentina and Bolivia, protection may be increased surreptitiously, with no nominal raising of duties, by the simple expedient of marking up the official valuation.

**PROTECTION AGAINST UNFAIR COMPETITION**

Most countries have laws which protect domestic producers from unfair practices on the part of foreign competitors. Infringements on patents, for instance, and articles marked to simulate domestic goods protected by trade-mark are frequently not only barred, but are subject to confiscation, as well. The purpose of such protective legislation is clearly expressed in Section 337 of the United States Tariff Act of 1930: "Unfair methods of competition and unfair acts in the importation of articles into the United States, or in their sale by the owner, importer, consignee, or agent of either, the effect or tendency of which is to destroy or substantially injure an industry, efficiently and economically operated, in the United States, or to prevent the establishment of such an industry, or to restrain and monopolize trade and commerce in the United States, are hereby declared unlawful. . . ." Alleged unfair practices are to be investigated by the Tariff Commission, and its findings, if supported by evidence, shall be conclusive, except that appeals on questions of law only may be taken to the Court of Customs and Appeals. The President, acting on the Commission's findings, shall then direct that "articles concerned in such unfair methods or acts, imported by any person violating the provisions of the Act, shall be excluded from entry into the United States. . . ."

These broad powers over unfair competition place in the hands of the Tariff Commission a mighty instrument for granting additional tariff protection to American producers. While the Commission has been guiltless of such abuse of this power, the investigations instituted by the Commission, either upon complaint or upon its own initiative, have, nevertheless, proved expensive and troublesome to importers. During the period of investigation, which varies in duration from one to two years, imports of the goods in question are permitted only under bonds equal to the domestic value of the goods. In case the Commission's investigations result in a finding of unfair competition, the order of exclusion is made permanent, and importers are required either to export the banned merchandise or to have it destroyed under customs supervision. If the goods have already passed into the hands of consumers, which is frequently the

## 360 International Trade and Commercial Policy

case, the importers must forfeit their bonds, since they cannot export or destroy the merchandise. If, on the other hand, the Commission finds no violation of the law, importers receive no indemnity.<sup>8</sup>

### MARKS-OF-ORIGIN REQUIREMENTS

In order to protect domestic producers from unfair competition, such as the pirating of domestic trade-marks, and inform consumers of the origin of their purchases, so that they may not be misled, many countries require that imported goods be marked in such a way that their country of origin may be readily ascertained. When marks-of-origin legislation is employed simply to prevent unfair competition in foreign trade, it carries no suggestion of administrative protection. In many countries, however, marking requirements have been perverted into an instrument for the protection of domestic industry, rather than used merely for the prevention of unfair competition.

In some instances, marking requirements have apparently been legislated for the express purpose of providing economic protection.<sup>9</sup> But, even when legislators, in passing such legislation, are guiltless of any intent to restrict imports, the necessary result of marking requirements is to obstruct the international flow of goods. In the first place, marking adds to the cost of producing foreign goods, especially if a mark is difficult to affix to a designated article, or if the type of mark specified is unsuited to the size or shape of the commodity. This difficulty is illustrated by the United States requirements that individual cork stoppers from Spain be marked "Made in Spain"; the cost of marking exceeds the cost of the cork stopper itself. Fortunately, this requirement has recently been modified. A similar handicap to importing resulted from the Customs Court's interpretation of the American marking requirements re-

<sup>8</sup> *Ibid.*, pp. 55-69.

<sup>9</sup> Treasury officials and the Board of General Appraisers have made the following interpretation of American marking requirements: "The purpose of Congress in enacting the provision was to make competition with the domestic manufacturer more difficult and expensive, and if compliance with its requirements should render articles less desirable to purchasers, or should be more expensive and difficult, such fact could not defeat the intention of Congress, which was to reduce, if not prohibit, competition with American manufacturers." (T.D. 40771—C.A. 8961, March 25, 1925.) Cited in Percy W. Bidwell, *The Invisible Tariff*, Council on Foreign Relations, Inc., p. 69.

specting cigarette papers, which insisted that each individual paper, not each package, was a separate article and hence must be marked separately with the name of the country of origin. A second way in which marking requirements obstruct trade is by hindering the re-exportation of goods which do not find a ready sale in the national markets for which they were destined, where there is a lack of uniformity of marking requirements among the various countries, and where the cost of remarking is prohibitive.

The arbitrary administration of marking-requirements laws may severely handicap importers. The American law provides that imported goods illegally marked must pay additional duties amounting to 10 per cent of the value of the imported merchandise; at the same time, the law makes it possible for the importer to avoid the penalty duties by paying for remarking the imports under customs supervision. One American importer discovered that 20,000 bags of cocoa which he had imported from British African possessions were illegally marked, because the French language was used; he was able to avoid a \$15,000 penalty only by returning the goods to Liverpool. Another importer paid penalty duties of \$350, because the dust covers on a consignment of imported books were not marked "France," although the books themselves were so marked. The court held that the dust covers were "containers." Rubber marked "Burma" has been judged to be illegally marked; the correct marking should have been "British India." "Brasil" at one time was held to be an illegal marking. A manufacturer of chocolate almond bars had to pay penalty duties of \$2000 on shelled almonds in bags marked "Portucues," although the almonds were to be used exclusively in his own business.<sup>10</sup> The British Merchandise Act permits the use of the mark "Habana" only when it is applied to cigars manufactured in Cuba, and permits the term "sardines" to be applied only to fish caught off the coast of France. The name "California Port" is not allowed, but "California Sherry" is within the law.<sup>11</sup>

The mark of a foreign country on an article may be a severe handicap to its sale in a given market. Implicit in marking requirements is the assumption that, if domestic consumers were apprised of the foreign origin of goods, they would show a preference for

<sup>10</sup> Above cases cited by Bidwell, *The Invisible Tariff*.

<sup>11</sup> See de Haas, *The Practice of Foreign Trade*, p. 358.

## 362 International Trade and Commercial Policy

domestic substitutes. Marks-of-origin laws strengthen the effectiveness of popular boycotts of the goods of certain countries when national feeling against those countries is running high. During, and just prior to, the recent war, the marks "Made in Germany," "Made in Japan," and "Made in Italy" on any goods were a serious handicap to their sale in the United States. In Chinese markets, the mark "Made in Japan" arouses anything but enthusiasm for goods so marked. But marks of foreign origin are not always an encumbrance to the domestic sale of foreign goods. Shoes and men's clothes marked "Made in England," tweeds marked "Made in Great Britain," and women's gowns marked "Made in France" frequently sell in the United States at a premium over similar, domestically-made goods.

### THE CONTROL OF IMPORTS OF ANIMALS AND ANIMAL PRODUCTS

The misuse of sanitary regulations of imports of animals, meats, and meat products for economic ends provides one of the classic examples of administrative protectionism. The rigid inspection, quarantines, and even embargoes to which imports of animals and meats are subjected have been devised to protect domestic herds and domestic consumers from contagious animal diseases and parasites, such as hog cholera, pleuropneumonia, and the foot-and-mouth disease. Little criticism can be made of restrictions upon the importation of animals and meats from regions known to be infected, for the eradication of animal diseases has been extremely costly to both governments and animal raisers. Yet in every sanitary restriction of this sort there may be a concealed measure of economic protection.

As early as 1879, American exports of pork and pork products suffered a serious decline, as Italy and Austria-Hungary, and later Germany, France, and other European countries, embargoed imports of these American products on the ground that they were infested with trichinae. After rigid American inspection of pork and bacon for export—instituted in 1890 and 1891—had removed all danger of infection from these products, the embargoes were withdrawn. In some instances, however, it was evident that France and some other European countries delayed lifting the ban on American meats—even though all danger of trichinae had been

removed—in order to use the sanitary regulations as bargaining instruments in an attempt to obtain concessions in the American tariff.

American cattlemen have not been averse to demanding the subjection of imports of animals and meats to sanitary regulations which have had little justification on biological grounds. The outstanding instance of such perversion of sanitary regulations is the embargo on fresh meat imposed by the Tariff Act of 1930. Under earlier legislation, the Department of Agriculture had complete authority to restrict imports of animals and meats from any country, *or part of a country*, known to be infected with contagious cattle diseases. No serious complaints of abuse of the Department's discretionary authority were incurred. But in 1930, Congress, yielding to pressure from domestic livestock interests, legislated that absolute embargoes must be applied against imports of animals or meats from any country in which rinderpest or the foot-and-mouth disease exist, and *no* region in such country was to be exempted from the embargo. The chief country to be affected by the legislation was Argentina, whose livestock industry is carried on in two different regions, one in the north and one in the south. The northern area is infected with the foot-and-mouth disease, but the large Patagonian region in the south is free of the disease. The exclusion of Patagonian meat is therefore unjustifiable on biological grounds. The Argentine government launched a bitter protest against this discrimination; but, although the Roosevelt administration negotiated with Argentina a sanitary convention which would have supplanted the 1930 legislation with a policy that could have been defended on biological grounds, pressure groups succeeded in preventing Congressional ratification of the convention. The illwill which this legislation aroused in Argentina against the United States has never been completely allayed.

#### SANITARY REGULATIONS OF PLANTS AND PLANT PRODUCTS

National plant-quarantine laws, like veterinary regulations, are devised to afford biological, not economic, protection. As they have done with veterinary regulations, however, pressure groups have prevailed upon legislators and those entrusted with the administration of the laws to pervert these biological defenses to economic

## 364 International Trade and Commercial Policy

ends. If nurserymen find the competition of plants from a particular country distasteful, and if outright protection cannot be secured without exposing the government to charges of discrimination against a friendly nation, plant pests may be discovered which will warrant the exclusion of all plants originating in the country in question. Proof that the imported plants are not diseased is always difficult to establish.

In this respect, the United States has been both sinner and sinned against. In 1930, Great Britain prohibited the importation of American apples for the period between July seventh and November fifteenth, with the exception of two grades, because fruit flies had been discovered in shipments from this country. Imports of apples from Canada, however, were not covered by the order, although the apple maggot is also found in that country. New Zealand in 1924 placed embargoes on all imports of American grains, hay, plants, fruits, vegetables, and livestock because of the outbreak of the foot-and-mouth disease in California. The United States government demanded that the embargoes be restricted to products of the infected regions.

The United States permits the importation of rose stocks without limitations as to quantity and utilization, but allows finished roses, bud sticks, and cuttings to be imported only in limited quantities and for specified purposes. Yet both the restricted and unrestricted items come largely from the same regions. Finished rose bushes compete with domestic products, but rose stocks are the raw materials for the domestic rose-growing industry. From 1919 to 1926 narcissus and hyacinth bulbs were imported in unlimited quantities without restriction as to their use, but iris and gladiolus bulbs were rigidly restricted. Neither class of bulbs carried pests of any importance to the plant industry, and the Chief of the Bureau of Entomology and Plant Quarantine declared that there was no reason why one class of bulbs should be unlimited as to quantity and utilization and the other limited. In 1926, imports of Dutch narcissus bulbs were excluded, although interstate movement was permitted of all narcissus bulbs which had been disinfected or had been found free from infestation—an obvious discrimination against Dutch bulbs. The embargo against Dutch bulbs was lifted by the Department of Agriculture in December, 1936, six weeks before the reciprocal trade agreement with the Netherlands went into effect.

**THE LETTING OF PUBLIC CONTRACTS**

The broad expansion of the functions of states and governmental subdivisions during the past several decades has made the government one of the most important consumers. The expansion of the army, navy, and air force, the extension of educational facilities, the construction of vast highway networks and numerous public buildings, and the inauguration of public works programs have all compelled governmental units to enter the market as purchasers of goods and labor on a prodigious scale. Unlike private industry, however, the government is not always free to buy on the most favorable terms, for it has come to be a universally accepted principle that the government should give preference, wherever possible, to domestic products. Although this preference to domestic goods is openly conceded only when the prices, quality, and conditions of sale of the foreign and the domestic goods are equal, the manipulation of price calculations and the character and form of public specifications for the delivery of goods make discrimination easy.

In comparing prices, for instance, the prices of foreign goods can be interpreted to include the addition of import duties, although the government has the right of duty-free entry. Some countries have gone so far as to forbid the consideration of foreign bids for public contracts, unless the bids of domestic concerns are disproportionately higher than those of foreign concerns. The Austrian government at one time refused to consider that domestic prices were high enough to warrant the consideration of foreign bids if they did not exceed the foreign prices of the articles in question by at least eight per cent; Bulgaria and Roumania had similar laws, but their limit of tolerance was five per cent. Specifications can be drawn so as to exclude foreign goods; for example, brands may be specified which can be supplied only by domestic producers. Colonial powers have been known to use their political position to compel their colonies to give preference to the products of the mother country in filling public contracts of the colonial governments, although foreign products were offered at lower prices. Grunzel refers to the Egyptian practice of setting a time limit for the fulfilment of public contracts and of making this time limit extremely short; English firms were informed of the forthcoming contracts far enough in advance so that they could be prepared to deliver the goods upon short notice, but



## 366 International Trade and Commercial Policy

foreign firms frequently found it impossible to complete the contracts within the allotted time.<sup>12</sup>

Besides favoring domestic producers of the products which it purchases itself, the state may offer to its citizens various inducements to buy domestically-produced goods. In its purchases of supplies from domestic producers, for example, the government may require that, wherever possible, these producers use materials which are also produced at home.

### OTHER PROTECTIVE MEASURES

Propaganda and pressure from economic groups may succeed in effecting a high degree of protection through the informal boycott of foreign products. The "Buy British" campaign in the 1930's is an example of such a boycott. Protective boycotts may be officially sponsored by the government, or they may develop spontaneously among the people, as did the boycotts against German goods in many countries following the Nazi pogroms in the middle 1930's, and those against Japanese goods in 1937-1938, following the invasion of Shanghai. These movements may represent attempts to provide general protection against imports of all foreign goods, like the unsuccessful "Buy American" campaign during the period of widespread unemployment in the 1930's, or they may be directed against the goods of a particular nation as an expression of strong disapproval of certain activities of the boycotted nation. How effective these mass refusals to buy can become is evidenced by the many attempts of the Japanese to terminate the Chinese boycott of Japanese goods after the beginning of the "China Incident." Usually, however, such boycotts tend to be short-lived.

The task of instructing the people about the blessings which flow from the purchase of domestic goods—in contrast to foreign products—has on occasion been undertaken by particular trade groups. A few years ago, American beet-sugar producers revealed to Americans the large numbers of workers which the beet-sugar industry then employed and announced that the industry could employ a great many more if consumers would only confine their purchases to sugar made from domestic beets and refuse to buy that produced from imported sugar cane. The Chemical Foundation has flooded

<sup>12</sup> *Op. cit.*, p. 188.

the country with pamphlets picturing the dangers which the purchase of imported products holds for the country. Great Britain is presently eager to encourage the British motion picture industry. While direct, official encouragement has been extended to the industry by means of display quotas, a considerable measure of indirect protection has also been given British pictures. Since V-E Day British press and radio criticism has become markedly "anti-Hollywood." "British pictures are praised and given the greatest encouragement by the critics while the best Hollywood efforts are derided and treated with a sort of bitter antagonism that is most noticeable."<sup>13</sup>

Marketing regulations sometimes discriminate against foreign products. Most European countries have milling regulations which stipulate that certain proportions of local flour shall be admixed with all imported flour, or with all flour made of imported grain. In Switzerland, the issuance of permits to import foreign eggs is made conditional upon the purchase of stated proportions of domestic eggs. France requires that all horses imported for sale be sold only on the Paris market, where municipal sales taxes are much higher than in other local markets, and that they be sold only on two or three specified days each week—and then only during the last hour or two of the market, after the demand is usually sated.<sup>14</sup> The British Cinematograph Films Act of 1938, as amended in April, 1945, sets the proportion of British-made films that must be released in Britain annually at 20 per cent for 1945, 22½ per cent for 1946, and 25 per cent for 1947. It is expected that the Act will be further amended in 1948 to attain its ultimate goal of 30 per cent.<sup>15</sup>

#### CONCLUSION

While the foregoing discussion of indirect protectionism makes no pretense of analyzing the problem in all its ramifications, sufficient cases have been described to indicate the scope of the problem and to illustrate the extreme flexibility of the device. As has been indicated in the preceding pages, most of the restrictions which are classed as administrative protection have originated as perfectly

<sup>13</sup> *New York Times*, December 4, 1945.

<sup>14</sup> J. B. Condliffe, *The Reconstruction of World Trade*, pp. 196-203.

<sup>15</sup> *New York Times*, December 4, 1945.

## 368 International Trade and Commercial Policy

justifiable government controls to promote such desirable social ends as the safeguarding of health and the ensuring of fair competition. Private industry cannot always be trusted to protect the public's interest in such matters, and consumers are not usually well enough informed to safeguard their own welfare. Nevertheless, these necessary and desirable safeguards can be quickly and unobtrusively converted into an extra form of protection, especially during an emergency; the line between their legitimate and their illegitimate uses is indeed difficult to draw. At their worst, they can become under-handed and evasive forms of discrimination which engender suspicion, illwill, and retaliation.

But the elimination of this type of protection, desirable as it may be, is not easy. No satisfactory definition of the evil to be proscribed can be drawn up, because new forms are constantly appearing. The outlawing of the practices by treaty offers little promise of success as long as there is a deep-seated belief that the national welfare demands a large measure of protection. Not until there is a strong conviction among the nations of the world that human well-being will be best served by a general lowering of trade barriers can the uses of the instruments of indirect protection be expected to be confined to their legitimate purposes. Moreover, trade liberalization is scarcely compatible with economic planning and the quest for economic self-sufficiency, which have become such dominant factors in domestic policy in recent years.

### PROTECTIVE EXCISE TAXES

Another instrument which has come into use in recent years as a means of providing protection for domestic industry is the excise tax. Protective excise taxes are imposed, not primarily for the purpose of raising revenue, but for the purpose of discriminating against goods of foreign origin. Excise taxes designed to restrict imports are of two types: import excise taxes and processing excise taxes. Import excise taxes are taxes levied on the importation of goods where no corresponding taxes are imposed on the competing domestic articles. In the United States, these were originally applied chiefly to goods of types produced in this country, although more recently they have also been applied to many commodities not produced here. Processing excise taxes are taxes levied on the first

processing of imported materials, and are generally imposed on goods which either are not produced domestically or are produced domestically in only negligible quantities. Although the foreign materials selected for taxation may not be *identical* with the domestic materials for which protection is desired, however, they are always materials which are keenly *competitive* with domestic products. The American processing tax on coconut oil, for instance, was designed solely to protect the domestic production of butter; coconut oil is a component of butter's competitor, oleomargarine.

The import excise taxes introduced in the United States in 1932 for the purpose of protecting domestic industries are to all intents and purposes identical with tariffs, with one important exception. While they are levied, assessed, collected, and paid in the same manner as duties under the Tariff Act of 1930, they cannot be changed by the President in accordance with the flexible provisions of the Tariff Act; but they may be altered by the chief executive under the Reciprocal Trade Agreements Act of 1934. The processing type excise taxes are, like the import type, not subject to alteration under the flexible provisions of the Tariff; but, unlike the latter, they are not even subject to change under the Trade Agreements Act.

In the United States, the import type of excise tax is used much more extensively than the processing type. Articles on which import excise taxes are levied include petroleum and petroleum products, lumber, coal, copper and materials containing copper, and a long list of vegetable, animal, and fish oils. Processing excise taxes are now imposed only on palm oil, palm kernels oil, coconut oil, and mixtures and manufactures thereof. Despite the limited use of processing taxes, however, they have been much more productive of revenue than excise taxes of the import type. In 1936 the former yielded revenues of nearly twenty-nine million dollars while the latter yielded less than twelve million dollars.

As instruments of protection, excise taxes have certain practical advantages over tariffs. In the first place, they are less apt to be tampered with than tariffs, since they may not be reduced by the operation of the flexible provisions of the tariff, nor, in the case of processing taxes, even in reciprocal trade agreements negotiated under the Act of 1934. In the second place, excise taxes can be much more easily legislated than tariffs. Any tariff revision opens up the

### 370 International Trade and Commercial Policy

whole tariff list to revision and makes it the subject of general log-rolling, with the result that duty increases are usually won for a much larger number of commodities than was originally intended. Such general increases in import duties frequently cause serious embarrassment to the party in power, and may even interfere with the passage of the contemplated law. The creation of new excise taxes, on the other hand, avoids general tariff revision, and is accomplished with little more than a dim realization by the public of the protective character of the taxes. Finally, excise taxes are fairly secure against presidential veto, for they are incorporated into a general revenue act and usually constitute only a minor item of the act. However distasteful a particular protective excise tax may be to the President, experience shows that he will almost never reject a complete revenue bill in order to kill merely one or two minor taxes.

The adoption of such taxes by the United States in 1932 and the years following testifies impressively to their utility as an instrument of protection. Despite the demand from many sources for increased protection in a period when production was declining and unemployment increasing, any general tariff increases were out of the question, because of the widespread criticism of the high rates of the Hawley-Smoot Act. Furthermore, the Democratic party had gone on record during the presidential campaign of that year as favoring a reduction in tariff rates, and, after the election, had proceeded to carry out its promise in part through the Reciprocal Trade Agreements Act of 1934 and the many trade agreements negotiated under the Act.<sup>16</sup> But, unpromising as the prospects for greater protection appeared to be, at least through tariff increases, various interests did succeed in securing protection—by means of excise taxes. In granting protective excise taxes, Congress became truly prodigal; taxes were made considerably higher than the traditional principle of equalizing foreign and domestic costs of production demanded. Little wonder that this new implement of protection has won innumerable new friends!

Protective excise taxes are objectionable, on economic grounds, for precisely the same reasons that protective tariffs are—they re-

<sup>16</sup> The devaluation of the dollar in 1933 and 1934 tended to offset the direct tariff reductions that were later made in the Reciprocal Trade Agreements.

strict international specialization. They are especially obnoxious when they are levied primarily upon necessities and raw materials, such as petroleum, coal, lumber, copper, oils, and fats—the products which have been subjected to protective excise taxes in the United States. It is doubtful whether these taxes are of any benefit to industries on an export basis, for the foreign materials which would otherwise have been admitted are only diverted to the export market, where they tend to displace exports from the country levying the taxes. The claim that they tend to become less permanent than tariffs is not borne out by American experience; with one exception, none of the excise taxes levied has been repealed or allowed to expire when it was supposed to. Finally, “our unfamiliarity with this new instrument of commercial policy, the concealed, undercover manner of its use, and the difficulty of resisting it render it more insidious and more dangerous, at the present time, than the protective tariff.”<sup>17</sup>

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<sup>17</sup> C. R. Whittlesey, “Excise Taxes as a Substitute for Tariffs,” *American Economic Review*, Vol. XXVII (December, 1937), p. 679. I am indebted to Professor Whittlesey’s article for the material in this section.

## ***Commercial Treaties. The Most-Favored-Nation Clause***

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### COMMERCIAL TREATIES

The expansion of commerce beyond national boundaries and the increasing discrimination against foreigners and foreign products throughout the world have aroused every nation to the need for securing and protecting the rights and privileges of its citizens and goods in foreign countries, and for assuring its nationals and its products treatment abroad at least as favorable as that accorded to the nationals and products of third countries. The chief instrument for securing more favorable treatment for a country's nationals abroad and for insuring them against discrimination in foreign markets is the commercial treaty.

A commercial treaty is merely a contract between two or more nations, which deals with any part of their economic relations, although the relations usually dealt with are chiefly commercial. These international compacts appear in a variety of forms and under a diversity of titles, according to their importance or duration. The more formal compacts are generally known as "treaties" or "conventions" and are negotiated by the chief executive, with parliamentary approval.<sup>1</sup> Subordinate or special subjects may be dealt with in less formal compacts known as "agreements," "modus vivendi," "exchange of notes," etc. The latter are frequently effected

<sup>1</sup> In the United States the Constitution provides that the President "shall have power by and with the advice and consent of the Senate to make treaties, provided two-thirds of the Senators present concur; . . ." Article II, Section 2, paragraph 2.

by a mere exchange of notes between the foreign minister of one country and the ambassador of the other. The conventional regime of international commerce may also be established by clauses of treaties of friendship, treaties of peace, and other treaties of a political character.

Commercial treaties may cover a wide variety of subjects; in fact, every object of national economic activity may be an object of international negotiations and treaties. Besides customs questions, commercial treaties may deal with such matters as fishing rights, the treatment of one another's shipping in the countries' respective ports, the ownership of property by foreigners, the conditions of immigration, the rights of foreign business associations, the protection of patents, trademarks, copyrights, and other industrial rights, the payment of taxes, and sanitary and veterinary regulations. Treaty-making was in earlier times concerned more with securing the right to participate in a particular trade than with the details of customs rates. More recently, tariff rates have come to be the most important subject of negotiations, for a presumption has grown up that trade is in general open to all and that a foreigner, as a foreigner, will not be deprived of ordinary civil rights.<sup>2</sup> Although agreements between leading powers and economically backward nations, which grant the former certain exclusive privileges in the territory of the latter, such as the building and operation of railways and the exploitation of natural resources, are still of considerable importance, there is a tendency to restrict the use of the term "commercial treaties" to agreements dealing with tariff questions.

Unlike treaties of peace, which are perpetual unless altered by mutual consent or by war, treaties of commerce are usually negotiated for a fixed term of years. It is common, however, to include in commercial treaties a provision requiring notification before the treaty is terminated; unless such notification is given by one of the contracting parties, the treaty is automatically renewed for another term, equal to, or shorter than, the original term. Thus, the commercial treaty of 1828 between Prussia and the United States, orig-

<sup>2</sup>The treaties and agreements negotiated during the 1930's also dealt with the newer forms of trade barriers, such as import quotas and exchange restrictions; postwar treaties will in all probability be as comprehensive as these later treaties.



### **374 International Trade and Commercial Policy**

inally signed for a twelve-year period, remained in force until the two countries went to war in 1917; it contained a provision for its continuance unless one of the parties to the agreement should give notice of termination one year in advance of such termination—and neither party chose to terminate it. Before the first World War, commercial compacts were concluded for a relatively long period, generally about ten years; but the economic and political unsettlement which has characterized the period since the war has caused nations to become more cautious in their treaty commitments. As a result, the *modus vivendi* has recently come to play a much more important role than formerly. This type of agreement is usually terminable by either party upon a few months' notice, after it has been in effect for a brief period, commonly one year.

While commercial treaties are in most cases bilateral, i.e., between two nations only, multilateral agreements—those to which more than two nations are signatory—are not uncommon. The increasing recognition that nations have many interests in common and face many problems which can be effectually handled only by multilateral treaties has brought wider use of this type of treaty. Multilateral treaties usually deal with special questions of international trade; the Brussels Sugar Convention of 1902, the Barcelona Convention of 1921 relating to the freedom of transit, the Convention of Geneva of 1923 relating to the simplification of customs formalities, and the Geneva Convention of 1930 providing a uniform law for bills of exchange and promissory notes are examples of such special multilateral treaties. Multilateral agreement may be embodied in one multilateral treaty or in a series of bilateral treaties, each of which is the result of collective discussions and decisions and all of which have the same content.

Many administrative questions and questions concerning the legal and fiscal bases of trade were settled in the inter-war period by the calling of a diplomatic conference and the signature of a multilateral convention. This procedure has proved to possess several advantages. (1) It often makes possible the rapid achievement of some desired end which would require many years to achieve by bilateral negotiations. (2) There are certain actions which no country, or pair of countries, would care to take unless many other countries took similar action simultaneously. (3) A system established by a

multilateral treaty possesses greater stability than can be achieved even by a whole network of bilateral treaties. (4) In a bilateral agreement there must be an approximate equivalence in the concessions given and received by each contracting party; in a multilateral agreement it is not necessary that the concessions granted between any two countries be even approximately equivalent so long as each party's concessions are offset by the *total* concessions which it obtains from *all* the other parties. The opening of international conferences on questions of commercial policy to all nations, however, raises specific difficulties which often limit the accomplishments of multilateral conventions. (1) National differences in law and practice and in economic conditions are sometimes so great that agreement is possible only between a small number of states. (2) When world-wide agreement is sought, there is a tendency to whittle down the obligations imposed by the agreement to such an extent that the code falls short of the existing practice in the more advanced states. The weakening of the obligations for the purpose of securing the signatures of doubtful countries may, moreover, be of no avail, for these countries may fail to ratify. (3) After a multilateral convention has been laboriously prepared, negotiated, and signed, it still remains uncertain whether the minimum of ratifications necessary to bring it into force will be obtained.<sup>8</sup>

The agreement incorporated into commercial treaties may be either direct or indirect. Direct agreements specify in great detail the rights of citizens and the treatment of commodity imports: specific rates of import duties are set, the rights and obligations of consuls are specified, and the conditions under which foreign firms can establish themselves are set forth. Indirect agreements merely lay down a general rule or yardstick by which the treatment of the nationals and the goods of the other country is determined. Of the various rules which from time to time have been invoked in these indirect agreements, two have come into common use in modern times: national treatment and most-favored-nation treatment.

Before embarking upon a discussion of national and most-favored-nation treatment, it should be pointed out that treaties are not the

<sup>8</sup> League of Nations, *Commercial Policy in the Post-War World*, Report of the Economic and Financial Committees, II. Economic and Financial, 1945. II. A. 7. pp. 26-28.

## 376 International Trade and Commercial Policy

exclusive source or measure of the rights and privileges of aliens in a given country. The absence of any treaty between two countries does not mean that the citizens of one country have no rights in the other country. Numerous rights and privileges are assured to aliens in all civilized countries through domestic laws; general laws may apply to nationals and aliens alike, or special laws may concern aliens alone. In most civilized countries, the legal position of aliens in the enjoyment of civil, contrasted with political, rights is today that of practical assimilation with nationals—except for certain minor disabilities in some countries; if an alien owns any nationality at all, he must be accorded protection of his person and property. Furthermore, international law and established custom have secured for foreigners a certain standard of justice and a minimum of rights relating to life, liberty, and property, by which a nation must be guided in its treatment of aliens, irrespective of any treaty that it may have with the alien's home country.

It should not be assumed that, the more specific a nation's treaties with a given country are, the more numerous are the rights of its citizens in that particular country compared with those of other foreigners, or that, because nothing is said about certain rights in treaties with a given country, foreigners in that country are without those rights. The contrary may be true. For the more generous is the treatment accorded to foreigners by the laws of a country, the less is the need for a detailed guarantee of the rights of foreigners by treaty. For this reason, treaties between highly developed nations do not need to be as specific and complete with reference to fundamental rights as treaties between countries on a lower plane of civilization, or between countries fundamentally different in morals and culture.

### NATIONAL TREATMENT

The national treatment clause of commercial conventions provides that the party granting national treatment shall guarantee to nationals of the other party the same rights and privileges, in all matters to which the pledge of national treatment relates, that the former accords to its own nationals. Usually national treatment is reciprocal, i.e., each party pledges national treatment to the citizens and subjects of the other; but the extension of national treat-

ment may be unilateral. The more common matters in which national treatment is accorded include those relating to commerce, navigation, industry, taxation, trading companies, and civil rights.<sup>4</sup> The type, scope, and extent of national treatment differ in different treaties. It may deal with only a few or with many topics; it may be extended to the entire territory of a power, or it may be excluded from certain areas under a nation's jurisdiction.

Since the very object of tariffs and other forms of trade restriction is to secure more generous treatment for native goods than for foreign goods, national treatment applies only to the rights and privileges of persons, not to goods. Moreover, it is the policy of most nations to reserve for their own citizens certain rights and privileges which for one reason or another are not extended to aliens. It has been the policy of the United States, for example, to reserve the coasting trade exclusively for vessels of its own citizens. Therefore, a clause is incorporated into all American commercial treaties in which national treatment is pledged on a scale sufficiently broad to include coastwise shipping, which expressly excepts this trade. Some countries also reserve national fisheries for national vessels. Other fields in which discriminatory treatment in favor of a country's own nationals is frequently provided in commercial treaties are the acquisition and possession of the soil, especially in agricultural districts, and the practice of certain professions and trades, such as pharmacy, brokerage, peddling and other itinerant trades.

At the same time, commercial treaties frequently guarantee ex-

<sup>4</sup>The term "national treatment" is rarely, if ever, found in commercial treaties. How well the term describes the relevant clause, however, is clearly indicated by the following clause from the Spanish-British treaty of 1922:

"The subjects of each of the two Contracting Parties shall have liberty freely to come, with their ships and cargoes, to all places and ports in the territories of the other to which subjects of that Contracting Party are or may be permitted to come, and shall enjoy the same rights, privileges, favours, immunities and exemptions in matters of commerce and navigation as are or may be enjoyed by subjects of that Contracting Party.

"The subjects of each of the Contracting Parties shall not be subject in respect of their persons or property, or in respect of their commerce or industry, to any taxes, whether general or local, or to imposts or obligations of any kind whatever, other than those which are or may be, imposed upon subjects of the other. . . ." (Article I of the Treaty of Commerce and Navigation between Spain and Great Britain of 1922.) Quoted in Paranagua, *Tariff Policy*, p. 162.

### 378 International Trade and Commercial Policy

ceptional treatment for resident aliens. The latter are usually exempt from personal military service in the country of residence; from all forced loans, imposts, and extraordinary military requisitions and contributions, except the quartering of troops; and, in certain countries, from the compulsory acceptance of judicial and municipal functions, except jury service and the office of guardian of wards of their own nationality.

Although the reciprocal granting of national treatment may, on the surface, appear to establish reciprocally equal treatment, it may, in fact, fail to do so. National treatment is merely treatment equal to that accorded to nationals of the country granting such treatment. In a well-ordered state, where persons and property are secure under the law, and where citizens enjoy a large degree of industrial and commercial freedom, national treatment will mean much more than in a backward state, where security and enterprise are more restricted. Even countries in the same plane of development may have widely differing domestic policies respecting fiscal, industrial, and commercial matters. Income, property, and corporation taxes, for instance, may be higher in one country than in another; certain trades and professions may be treated liberally in one country, while they may be burdened with various restrictions and charges in another; in one state patents may extend over a long period without any requirement that the patented process be used—this is the case in the United States—while in another state the production of the patented article must be started within a stipulated period in order to enjoy the protection of the patent rights; patent fees may vary widely in different countries. Obviously, reciprocal national treatment is not necessarily reciprocal equal treatment.

National treatment is nowadays the rule between equals. But world powers have on occasion exacted from weaker nations some form of special privilege and have secured for their citizens partial or complete exemption from the operation of local law. At different times, China, Egypt, Morocco, Iran, Thailand, and Turkey have granted extraterritorial rights to states of European civilization. This means that nationals of the European states are subject, not to the laws of the country granting extraterritoriality, in which they may be resident, but to laws of their homeland and to the jurisdic-

tion of courts and authorities established and regulated by their own municipal regulation. The extent of this exemption from local law depends almost entirely upon treaty.

### RECIPROCITY

Every nation has a twofold object in the adoption and development of a commercial policy: (1) to gain and to preserve for itself advantages, and (2) to avoid and guard against disadvantages. In earlier times, nations sought to realize these objects through "reciprocity" treaties, i.e., agreements whereby each of the parties to a treaty makes special concessions to the other with the intention that the transaction shall be looked upon as a particular bargain whose benefits are not to be extended automatically, generally, and freely to other states. Favors granted in "reciprocity" treaties are, in other words, exclusive, not generalized.

### MOST-FAVORED-NATION TREATMENT

It is always a matter of considerable importance to a country to be assured that the treatment its citizens receive at the hands of another country shall be not less favorable than that which the other accords to the citizens of a third country. Now it has frequently happened that "reciprocity" arrangements between two nations have been rendered valueless, in greater or lesser degree, because one of the contracting parties has granted to some third nation even more liberal concessions than it had granted to the other. In order to obviate this disadvantage, it became common practice to stipulate in commercial treaties that each of the contracting parties should grant to the other party *every* concession granted to any third nation. This stipulation has come to be known as the "most-favored-nation clause." The term is a misnomer, however, for the purpose of the clause is not to establish a nation *more* favored than others, but rather to maintain *equality* of treatment and to insure to each state that it will at all times be as favorably treated as the state which is most favored. Culbertson rightly suggests that a more truly descriptive term would be the "equally-favored-nation clause." The clause was devised, furthermore, to insure to the contracting states the benefits, not only of concessions previously made, but also of

### 380 International Trade and Commercial Policy

those that might be made at some future date by either of the contracting states.

While national treatment bars discrimination by either of the contracting countries against citizens of the other, compared with the treatment accorded its own citizens, most-favored-nation treatment excludes discrimination against one foreign nation compared with another foreign nation. Frequently, treaties guarantee national treatment of persons *and* most-favored-nation treatment of goods.

Most-favored-nation agreements may be "unrestricted" or "restricted," depending upon whether they apply to all matters relating to commerce, navigation, and industry, or are limited to certain specific subjects, such as customs duties and prohibitions, consuls, access to ports, etc. The Treaty of 1911 between Great Britain and Japan, which grants most-favored-nation treatment "in all that concerns commerce, navigation, and industry," illustrates the unrestricted form of the most-favored-nation clause. The Convention of 1904 between Russia and Germany, on the other hand, limited most-favored-nation treatment to the "products of the soil or of industry" of either country, while the Convention of 1926 between France and Greece granted most-favored-nation treatment only to Greek wines. Sometimes a distinction is made between the restriction of the *topics* covered by the agreement and the restriction of the *states* covered. The most-favored-nation agreement concluded between France and Germany in Article XI of the Peace of Frankfurt (1871), for example, was formally restricted to those concessions which either of the two nations granted to any one of the following states—England, Belgium, Holland, Switzerland, Russia, and Austria; the Convention of 1922 between France and Canada granted to Canada most-favored-nation treatment only with regard to concessions in favor of the United States. Ordinarily, the comprehensive coverage is intended when reference is made to the "most-favored-nation clause."

The operation of the most-favored-nation clause is usually bilateral, i.e., it is extended to each of the contracting parties. But this is not always the case, especially in treaties between dominant powers and lesser states, and sometimes between victor and vanquished. In the Treaty of 1856 between the United States and Siam, most-favored-nation treatment was unilaterally accorded the United

States by Siam, but the United States made no reciprocal extension of the same privileges to Siamese subjects. Another example of unilateral most-favored-nation treatment is found in the Treaty of Versailles; under this treaty Germany undertook to give most-favored-nation treatment to the Allies for five years, but was assured of no similar treatment by the Allied Powers.

The most acrimonious disputes concerning the most-favored-nation clause—and no feature of commercial treaties is so much discussed and so hotly disputed, both in legal and economic writings and by politicians—are those revolving about the unconditional and the conditional interpretations of the clause. Under the unconditional interpretation, any advantage granted by either contracting party to a third party accrues automatically, and without compensation, to the other party. An example of the most-favored-nation clause in its most general and unconditional form is found in the 1911 Treaty between Great Britain and Bolivia: “The High Contracting Parties agree that, in all matters relating to commerce and industry, any privilege, favor, 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-favored nation.”<sup>5</sup> According to this agreement, any reduction in import duties which Bolivia might grant to a third nation, say the United States, would be extended freely, immediately, and automatically to Great Britain. And Great Britain need make no concession to Bolivia in order to obtain the benefits of the lower duties, even though the United States may have had to make substantial concessions to Bolivia in order to secure them.

The conditional form of the most-favored-nation clause, unlike the unconditional form, distinguishes between concessions granted gratuitously and concessions purchased at a price. According to this interpretation of the clause, either contracting party must extend to the other, immediately and gratuitously, any favor which has been *gratuitously* granted to a third country. But any favor which a third

<sup>5</sup> Cited by William Smith Culbertson, *International Economic Policies*, D. Appleton and Company, 1925, p. 61.



## 382 International Trade and Commercial Policy

country *purchases* from either contracting party need not be extended to the other party except upon receipt of a similar or equivalent concession. The Treaty of 1911 between the United States and Japan illustrates the conditional most-favored-nation clause: "Except as otherwise provided in this Treaty, the High Contracting Parties agree that, in all that concerns commerce and navigation, any privilege, favor, or immunity which either Contracting Party has actually granted, or may hereafter grant, to the 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 favor of that other state shall have been gratuitous*, and on the same or equivalent conditions, *if the concession shall have been conditional.*" (Article XIV).<sup>6</sup>

Both forms of the clause recognize in principle that any act by either party to a treaty, which makes a third party a "favored" nation, is contrary to the treaty and entitles the other party to the same favor. But, under the conditional interpretation, any favor granted to a third state *for a compensation* does not create, in the technical sense, a "favored" nation, and the other state can claim the advantages of the concession only by offering an equivalent compensation.

European states began to incorporate the most-favored-nation clause into their commercial treaties as early as the seventeenth century, and by the second half of the eighteenth century scarcely a commercial treaty was concluded by these countries which did not include the clause, either expressly stated in one of its variants or implied in the text. Since the middle of the nineteenth century, practically all European states have adopted the unconditional form of the clause, although some of these states have readopted the conditional interpretation since the 1920's.

The United States alone among the great powers consistently adhered to the conditional form down to 1923. The first commercial treaty that she signed after she had declared her independence—that with France in 1778—incorporated the conditional clause, and thereafter American officials almost invariably maintained this interpretation, even in the case of treaties which did not contain an express stipulation calling for compensation. At first, she obtained

<sup>6</sup> Cited in *ibid.*, p. 61.

fairly substantial advantages from this policy, especially in respect to navigation rights. Throughout most of the nineteenth century, however, she attempted little active bargaining, and secured few exclusive privileges from her conditional policy, except in treaties with Canada, Hawaii, and Brazil. Despite her aloofness from bargaining, she nevertheless received most-favored-nation treatment in most foreign markets. This is probably attributable to her use during this period of a uniform (single schedule) tariff, applicable to the exports of all nations without discrimination, and to the composition of her exports, which consisted chiefly of foodstuffs and raw materials—products which were not only largely non-competitive with European products and thus customarily on the free list, but were also in wide demand in European countries.

The United States has completely altered her attitude toward the most-favored-nation clause since the first World War and has now become the most ardent supporter of the unconditional form. In an exchange of notes with Brazil in 1923, the United States abandoned her previous conditional policy and accepted the unconditional most-favored-nation policy. She has vigorously championed the unconditional form in her negotiations under the Reciprocal Trade Agreements Act of 1934, at a time when the rest of the world has shown a strong inclination to veer away from the generalization of concessions granted in bilateral agreements.

Several factors are responsible for this shift in American policy. The conditional policy had given rise to numerous disputes, and the application of the policy constantly encountered serious difficulties. Furthermore, manufactured goods have grown to be a much more important element in American exports than they were in the nineteenth century; and, since exporters of these goods have to face much keener competition in export markets than they did before 1914, equality of treatment has come to be prized more than any grant of special concessions, which have a habit of evaporating overnight. Finally, the adoption of stronger protectionist policies by most countries has meant that special concessions to particular countries would seriously handicap exporters in countries not so favored. All in all, it is not surprising that the United States has reached the conclusion that equality of treatment with her competitors is the policy best designed to serve her interests.

## 384 International Trade and Commercial Policy

### CRITICISM OF THE CONDITIONAL MOST-FAVORED-NATION CLAUSE

At first glance, the conditional clause appears eminently fair and just. Why should any nation expect to get for nothing a reduction in tariff rates which a third nation has had to buy? If any nation can be assured of the opportunity of securing a reduction in the import duties of a foreign country upon the same, or equivalent, terms as a third nation, the principles of justice would appear to be satisfied. The conditional clause thus suggests an analogy to the Anglo-Saxon law of contracts, which requires a consideration in order to make a contract binding. The conditional version has been favored by some as a more effective instrument for bargaining than the unconditional version, because it does not involve "giving away" concessions to third parties. If third parties can expect to acquire duty reductions only by making concessions themselves, then, it is argued, they are more likely to make concessions. This is the reason why France abandoned her traditional unconditional policy after the first World War in favor of the conditional policy. It has been contended, finally, that highly protectionist countries are more apt to make reductions in their tariff walls if such reductions are not automatically generalized for many exporting countries. Country A, for instance, might be quite willing to grant Country B a reduction in import duties on, say, shoes if the latter could supply at the most only a small proportion of the former's imports of shoes, while she would be unwilling to make any reductions—for fear of injury to domestic producers—if other shoe-producing countries automatically received the same favor.

Yet, in practice, the conditional interpretation of most-favored-nation treatment has encountered serious difficulties and has been the source of bitter diplomatic disputes. The determination of just what conditional treatment means has necessitated frequent negotiation. What is to be considered an "equivalent" concession? If the United States grants Great Britain a generous reduction in American wool duties in exchange for a reduction in British duties on American typewriters, then the American reduction in wool duties would have to be extended to Argentina, provided the latter had a conditional most-favored-nation agreement with the United States and made a similar reduction in duties on American typewriters. But

is Argentina's reduction in typewriter duties to be considered the equivalent of Britain's if Argentina imports few, if any, typewriters? What if Argentina has previously reduced her typewriter duties? And what is to be regarded as an equivalent concession if Argentina has no import duty on typewriters? The United States will be the sole judge of the equivalence of the compensation. Frequently, moreover, each party to a treaty will make several concessions simultaneously, and only the sum total of concessions on each side may be regarded as an approximate equivalent. It will then be impossible to say exactly what has been paid for any individual concession. Little more can be said for the conditional most-favored-nation clause than that it places upon a nation the obligation to enter into negotiations for equal treatment with the other contracting party. In some cases, it has even been held that concessions granted by one country to another depended upon peculiar relations between the two countries, and hence could not be matched by *any* third country.

Another disadvantage of the conditional interpretation is that, if it is effectively pursued, it is almost certain to result in a multiplicity of rates on some articles, for the rates on any article on which conventional reductions are made will vary according to the country of origin. Such a complicated tariff structure is costly to administer, it invites fraud, and it discriminates in favor of certain countries and against others. These discriminations can be removed only through a long and confused process of practically continuous negotiations; and, meanwhile, trade currents are kept in a state of constant fluctuation.

It is improbable that the maximum tariff reductions will be effected under the conditional most-favored-nation policy. When a nation obtains tariff concessions abroad through bilateral agreements based on the conditional most-favored-nation clause, it realizes that it will in the future have to make additional concessions in order to secure additional benefits, and that additional benefits may become indispensable if equality with foreign competitors is to be maintained. Anticipating the necessity of granting further reductions, a nation will naturally tend to hold some concessions in reserve. Initial reductions are therefore unlikely to be as great as they might be; but, if future negotiations are unsuccessful, further reductions

## 386 International Trade and Commercial Policy

which a nation might have been willing to make may never be made.

Culbertson has pointed out that United States adherence to conditional treatment under the tariff policy adopted in 1922 would have made our commercial policy embarrassingly inconsistent.<sup>7</sup> The Tariff Act of 1922 authorized the President to impose additional duties on imports from any country which in any manner discriminated against American commerce. But, since an active policy of conditional most-favored-nation treatment almost unavoidably introduces discriminations into a nation's tariff schedules, the United States would have found herself in the insupportable position of penalizing other nations for discriminating against her, while she was actively discriminating against others.

Finally, the conditional clause leads to the same results as the unconditional clause as soon as a country most of whose treaties are conditional makes one unconditional treaty. For, whatever concessions she makes to any other country, either gratuitously or for compensation, she must extend immediately and gratuitously to that nation with which she has an unconditional most-favored-nation agreement. But all concessions which she grants gratuitously to *any* country are to be extended gratuitously to *all* countries with which she has conditional most-favored-nation agreements.

### MERITS OF THE UNCONDITIONAL MOST-FAVORED-NATION CLAUSE

A conviction that only bilateral agreements based upon the unconditional most-favored-nation principle could be really effective in lowering trade barriers and supplying a truly satisfactory basis for the development of international trade led to its practically universal acceptance by European states during the half century preceding the first World War and to its readoption as one of the important bases for the reestablishment of world commerce in the postwar years. The unconditional principle is superior to the conditional principle in many respects. Its meaning is clear, and frequent and long drawn-out diplomatic wranglings are not necessary for its interpretation. It establishes uniform tariffs, regardless of the origin of imports, and thus avoids arousing the irritation, controversy, and international ill will which are the inescapable concomitants of discriminatory treatment. Professor Viner points out

<sup>7</sup> *Ibid.*, p. 101.

that "there is no case on record where a country whose exports have been subjected to higher duties than the exports from another country has acknowledged that such discrimination was justified."<sup>8</sup> Unconditional most-favored-nation treatment also assures each competing country that it will at no time during the life of the treaty be placed in a less favorable position in respect to competition with third countries than at the time the treaty was made.

The application of uniform rates to imports of similar commodities, regardless of the country of origin, has, however, an even more important advantage. Given the extent to which a country desires to permit imports, it insures that the imports will be provided by those countries which are willing to provide them at the lowest prices. It also furnishes a guarantee that, when duty reductions are granted to only one country, or to a few, the benefits of the reductions will not accrue to foreign exporters rather than to domestic consumers. When preferential treatment is accorded to only one country, there is always the possibility that that country will be either unable or unwilling to provide the full quantity of imports demanded by the importing country and that the deficiency must be made up by imports from other countries. In this case, the price of the imported commodity in the importing country will be the world price plus the unreduced duty which imports from nonpreferred countries have to bear; but exporters in the preferred country will receive the world price plus the amount of preference in duty which they enjoy in the importing country. This subsidy enjoyed by the preferred foreign exporters is made at the expense of the public treasury of the importing country. When the duty reduction is extended to all countries, the loss in revenue to the treasury in the importing country is offset by the lower prices paid by consumers; when the reduction is made to a country, or countries, supplying only a fraction of the imports, there is no corresponding gain to consumers to offset the loss to the treasury—only the preferred foreign exporters gain.<sup>9</sup>

Superior as the unconditional most-favored-nation principle has demonstrated itself to be, it has nevertheless been the object of

<sup>8</sup> *The Improvement of Commercial Relations Between Nations*, Carnegie Endowment—International Chamber of Commerce, p. 82.

<sup>9</sup> Cf. Viner, *Studies in the Theory of International Trade*, p. 82.

### 388 International Trade and Commercial Policy

numerous and insistent attacks. Protectionists have attacked it because they consider it merely a device for promoting free trade. Autarchists have opposed it because they want to abolish completely the individualistic basis of world economy and to replace it with a planned regime. But it has also been criticized by some who favor the individualistic world economy and the international division of labor. The latter have argued that unconditional most-favored-nation treatment is unjust because it permits countries which make no reciprocal compensatory concessions to enjoy favors which other nations have had to purchase at a substantial price. Fundamentally, this argument rests upon the untenable protectionist contention that every unilateral tariff reduction is a sacrifice.<sup>10</sup> But, even more important, it overlooks the fact that a very valuable concession is extended by the third country when the latter itself grants unconditional most-favored-nation treatment, irrespective of any concrete tariff reductions. A uniform rise in the import duties of the third country will cause the exports of other countries to that country to decline; but it will not necessarily destroy the trade of any one country with that country. The granting of *preferential* treatment by the third country to any one country, however, may result in the complete exclusion of the exports of unpreferred countries from the market of the third country. This advantage of unconditional most-favored-nation treatment has been plainly stated by Helfferich: "We have, indeed, a great interest in low duties upon our exports, but our interest in receiving the same treatment as other countries is immeasurably greater."<sup>11</sup>

Some have maintained that unconditional most-favored-nation treaties have tended to hinder the reduction of tariffs. For example, when country A negotiates successfully with countries B and C for mutual tariff reductions, country D may be unwilling to negotiate with country A, because under her unconditional most-favored-nation treaty with A she is entitled automatically to every concession which A has extended to B and C. Hence, country D receives substantial concessions from country A without having to lower her tariffs at all; whereas, had country A's reductions not been extended to country D gratuitously, the latter might have been willing to

<sup>10</sup> See Ch. XIII, pp. 307-308.

<sup>11</sup> Quoted by Haberler, *The Theory of International Trade*, p. 379.

make concessions to country A in order to acquire these concessions for herself.

In answer to this argument, it may be stated that A will probably still have duties for whose reduction D will be willing to pay a price. But, even if A becomes convinced that no reductions by D can be expected, it is open to A, as Haberler has pointed out, to make the granting of most-favored-nation treatment to D conditional upon the granting of tariff concessions to A by D. In other words, unconditional most-favored-nation treatment, instead of being the premise upon which trade relations between the two countries are based, may be placed as a final seal upon those relations. In the period before the first World War, Germany used to arrange all her tariff treaties so that they would terminate at the same time; then, in the year of their expiration, she would negotiate simultaneously for the renewal of them all, making the grant of most-favored-nation status dependent upon the conclusion of successful tariff negotiations and making the life of the most-favored-nation pledge co-terminous with the life of other provisions in the tariff treaty.<sup>12</sup>

The danger that the unconditional most-favored-nation clause might become an obstacle to tariff reductions has been largely overcome by the United States in her negotiation of agreements under the Reciprocal Trade Agreements Act through her refusal to consider as the subject of negotiations duty reductions on any commodity of which the other country is not a major supplier. Duty reductions granted to one country are thus not likely to constitute a major concession to any other country, and other countries are left with a strong inducement to enter into independent negotiations for reductions on additional goods.

Most-favored-nation treatment should be accorded to countries with non-bargaining, but low, tariff policies without a reciprocal pledge. The treatment of high-tariff countries which do not follow a bargaining policy, however, presents difficulties. Professor Haberler has suggested a promising method for dealing with such countries. If there is a possibility that the threat of withholding the pledge of most-favored-nation treatment from any such nation would induce the nation to negotiate, then the granting of the pledge should be made conditional upon duty concessions by that nation. If, on the

<sup>12</sup> *Ibid.*, p. 382.



## 390 International Trade and Commercial Policy

other hand, there seems to be little possibility that any threats will induce the refractory high-protectionist to come into line, the wisest course is to concede her unconditional most-favored-nation status. This course involves no sacrifice. On the contrary, failure to follow such a course will only force trade into uneconomic channels; goods which could have been obtained most cheaply from that nation will have to be obtained from higher-cost sources.

### EXCEPTIONS TO THE MOST-FAVORED-NATION CLAUSE

There are certain more or less recognized exceptions to the principle that a country which has been promised most-favored-nation treatment is entitled to receive trade privileges as generous as those accorded to any country. These exceptions may be expressly stipulated in treaties, or they may be merely implied. The most common of these exceptions is frontier traffic of a strictly local character. Since international boundaries are arbitrary and frequently divide regions which are economically homogeneous, the strict maintenance of customs barriers would work great hardship upon the inhabitants along both sides of the frontier. Consequently, frontier traffic is commonly exempt from customs duties. The extension of the same exemptions to other traffic would, however, place the nation on a free-trade basis, and general free trade might be contrary to its basic policy. Another exception to most-favored-nation treatment is the trade between a mother country and her colonies. Where the colonies are not incorporated into the customs area of the mother country, preferential duties are not infrequently accorded the mother country by the colonies, and accorded the colonies by the mother country. Such a system of preferential duties was adopted by Great Britain and the British Dominions at the Ottawa Conference in 1932. Colonial preferences have also been employed by the United States, France, Italy, and Spain. Still other exceptions to most-favored-nation treatment have been made in the case of countries which are closely related in respect to race, location, or economic ties. Both the United States and Cuba exclude other nations from the enjoyment of certain duty reductions which they have reciprocally pledged. Similar exclusions are to be found between Spain and Portugal, among certain Balkan countries, certain South American countries, and the Scandinavian countries.

Spain reserves the right to give special privileges to Latin American countries, and Portugal retains the right to extend preferences to Brazil. It also appears to have become an established principle of commercial policy that customs-unions, such as that formed after the first World War between Belgium and Luxembourg, are exempt from the jurisdiction of the most-favored-nation clause, unless otherwise provided by treaty.

Apart from these open and accepted exceptions, certain practices have come into use which not only violate the spirit of the most-favored-nation clause, but also seriously impair its effectiveness. Chief among these are the increasing specialization of tariff classifications, the use of various administrative regulations, the adoption of import quotas, and the negotiation of clearing and compensation agreements. While it is true that, through additions to the usual wording of the pledge, something can be done to mitigate such discriminations, there is nevertheless little reason to suppose that the pledge will regain its former importance as long as these practices continue. These discriminatory practices, like much of the criticism of the clause itself, show a strong disposition to increase during periods of political, monetary, and economic upheaval. They are one aspect of high protectionism and the quest for economic self-sufficiency.

### CONCLUSION

It should be pointed out, in conclusion, that the bulk of what is known as international law is based upon treaties, including commercial treaties. The nations of the world are thus not only the authors of the law governing their relations; they are also the courts which interpret this law and the officers which enforce it. There are, to be sure, international bodies of arbitration, such as the World Court at The Hague and the International Court of Justice established by the United Nations, whose function it is to adjust disputes between nations; but they have no means of enforcing their decisions upon nations which refuse to abide by them. Where vital national interests are not at issue, these courts and commissions may perform a useful work of arbitration. So long as nations possess unlimited sovereignty, however, they are usually reluctant to surrender what they consider to be their vital, sovereign rights or

## 392 International Trade and Commercial Policy

their possessions. Then, the arbiter of international disputes must be either the pressure of world public opinion—or military force. The stability of the system of international law thus rests fundamentally upon the fairness, simplicity, and clarity of the world treaty structure. The relative infrequency of disputes over the meaning of treaties testifies to the justice of treaties in general. The treaties that are most likely to be violated are those to which one party has become a signatory under duress.

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## *Tariff Bargaining*

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Tariff bargaining has been defined as "a process of negotiation between two countries, usually taking place shortly before the expiration of a previously existing commercial treaty, with the purpose of establishing their tariff relations on a definite footing."<sup>1</sup> The most conspicuous purpose of bargaining tariffs has been to obtain concessions from other countries; this was certainly one of their main purposes during the half century before the first World War. Bargaining tariffs are thus devices which employ import duties as a means of stimulating exports; they are constructed in such a fashion that tariff concessions may be traded for tariff concessions.

The securing of tariff reductions from foreign countries is not, however, the only purpose for which bargaining tariffs have been employed; they are also used to secure the removal of, or to forestall, discriminations against a country's exports. While high foreign tariffs tend to curtail a nation's exports, tariffs which discriminate against its products may completely exclude its exports from foreign markets. The guaranty of most-favored-nation treatment has therefore been the primary aim of nations in negotiating most commercial treaties. In some cases, particular concessions have been granted in order to obtain nothing more than such treatment. Whenever a nation has been unable to obtain general most-favored-nation treatment, it has made every effort to secure most-favored-nation treatment on at least those articles that it exports in competition with third countries. The importance which nations attach to obtaining *equality* of treatment is attested by the not infrequent extension by one bargaining state of concessions—granted to a second state

<sup>1</sup> From P. T. Ellsworth, *International Economics*, p. 367. By permission of The Macmillan Company, publishers.

### 394 International Trade and Commercial Policy

only after long haggling—to a third state without reciprocal concessions, on the ground that the state outside the bargaining circle has a single-schedule tariff and hence cannot practice discrimination against other states.

Bargaining tariffs, whether for the purpose of enforcing equality of treatment or for the purpose of securing concessions, have taken one of two forms: that of concessions, by which reductions in duties are granted to countries which either concede equality of treatment or make reciprocal concessions, and that of additional duties, in the nature of penalty or retaliatory duties, made applicable to countries which fail to accord satisfactory treatment. The principal advantage of the concessional method is that it appears to be more conciliatory: the offer of a reduction is less irritating than the imposition of a penalty. But the method of concessions may in effect become the equivalent of the penalty method. Nations which fail to grant satisfactory treatment receive no reductions, and therefore pay the unmodified, and higher, duties, which become in fact penalty duties.

Where tariff bargaining results in a reduction in duties, the economic effects differ according to the conditions of supply. If a reduction in a particular duty applies to only a fraction of a country's imports of the commodity affected, the public treasury suffers a loss in revenue, and no benefit accrues to domestic consumers in the form of a lowered price. The benefits of the duty reduction accrue solely to the producers in the favored exporting country. If, on the other hand, virtually the entire supply of the commodity is admitted at the reduced duty, the effect is similar to that of a general reduction in the rate. Customs revenues are diminished, to be sure; but the reduced customs revenues are more than counter-balanced by lower prices to domestic consumers.

The other method of tariff bargaining, that of imposing additional duties to imports from countries which do not concede satisfactory treatment, is combative in principle and usually irritating in its effects. When the additional (penalty) duties are put into effect simply in order to secure equality of treatment, however, rather than to obtain special concessions, and are therefore subject to termination as soon as equal treatment is granted, little reasonable ground for complaint exists.

The economic effects of the imposition of penalty duties, like the effects of granting reductions in duties, will differ with the range of application of the duties. If additional duties are applied only to the imports from a country that furnishes but a small fraction of the total imports of a given commodity, imports from that country will be excluded and will be displaced by additional imports from elsewhere. It is to be doubted that the domestic consumer will suffer from additional duties imposed on a small fraction of the imported good. But, if a large proportion of the supply, or the entire supply, is subjected to additional duties, such duties will impose an added burden on the domestic consumer in the form of a higher price. Penalty duties are therefore least burdensome when they are applied to an imported article which is supplied by several competing countries, no one of which supplies a large fraction of total imports; for then they merely establish a preference for one foreign producer, or several, over another, without penalizing the domestic consumer.

Tariff bargaining may be either "conciliatory" or "aggressive."<sup>2</sup> Bargaining may be considered to be conciliatory when a country abandons a measure of protection which it considers necessary for its domestic needs, and reasonable, in order to obtain concessions in foreign duties in favor of its exports. An example of this type of bargaining is that which has been carried on by the government of the United States under the Reciprocal Trade Agreements Act of 1934, discussed at length later in this chapter. Aggressive bargaining, on the other hand, consists in imposing new duties, or increasing existing duties, not because such duties, or such increases, appear desirable for the protection of domestic industry, but with the intent of withdrawing, or reducing, them later in exchange for a reduction in the import duties of foreign countries. Bargaining may be considered aggressive also when a country which recognizes that it is to the advantage of its own economy to lower its existing level of duties refuses to do so, except in exchange for reciprocal reductions by foreign countries.

Aggressive bargaining has been practiced extensively by the countries of Continental Europe. "The tariff policies and bargaining

<sup>2</sup> These terms are employed by Barrett Whale, *International Trade*, pp. 216 et seq.

### 396 International Trade and Commercial Policy

tariffs of the Continental European nations for several decades have included formal provisions for discrimination. While the tariff system has strongly tended to work itself out in practice to equal treatment of the commerce of all nations, it has been built on the assumption that discrimination and inequality are natural features of commercial policy and are to be removed only by mutual agreements among sovereign states."<sup>3</sup>

During the period preceding the first World War, practically every European state found it necessary to negotiate periodically for the removal of discriminations against its trade. France, Germany, Austria-Hungary, Russia, Italy, Spain, Portugal, Norway, Sweden, Bulgaria, Rumania, Greece, and Serbia pursued policies of tariff bargaining based upon the principle of discriminatory treatment. Great Britain, on the other hand, sought to secure equal treatment for her exports by granting equal treatment to the exports of all other nations. This policy was, of course, a natural corollary of her policy of free trade. The low-tariff countries of Switzerland, Belgium, Holland, and Denmark also based their commercial policies upon equal treatment. Although Switzerland and Belgium did negotiate some treaties in which duties on certain articles were made lower than the rates of their general tariffs, any reduction extended by treaty to one country was immediately extended to all others.

Tariff bargaining before 1914—which was based upon both general-and-conventional and maximum-and-minimum tariffs—tended to result, not in a mass of discriminations, but in a network of treaties which secured substantially equal treatment for the commerce of every nation. Equal treatment resulted primarily because each nation made it an aim of its policy to secure at least equality of treatment for its exports, and because the unconditional most-favored-nation clause was written into practically all commercial treaties. Thus, for at least eight years out of every decade, practically every nation of Europe was bound by a network of commercial treaties, each incorporating the unconditional form of the most-favored-nation clause, and normally imposed upon imports from

<sup>3</sup> W. T. Page, *Memorandum on European Bargaining Tariffs*, League of Nations, II. Economic and Financial. 1927. II. 28.

every other European nation identical rates of duty.<sup>4</sup> The other two years of each decade, however, were usually years of unsettlement, characterized by domestic tariff revisions and frantic international negotiations. It seemed reasonable to assume that the greater the concessions from its general rates that a nation was willing to make, the larger the reductions in the duties of other nations that it might expect to receive. The higher the rates were originally set above what was considered necessary for revenue purposes or for the protection of domestic industry, therefore, the greater were the concessions a country was in a position to make. Consequently, it became the common practice among European nations to revise their tariffs before the expiration of existing treaties, regardless of domestic economic conditions; and these revisions were invariably padded with a considerable trading margin. Furthermore, the amount of the padding added to the basic rates tended to increase from one revision of the tariff to another.

This tendency to increase the padding in tariff rates is revealed by the widening gap between the maximum and the minimum rates of the French tariff. Maximum rates were included in the tariff purely for bargaining purposes; the basic protective and revenue rates were the minimum rates. In 1892, the maximum rates were only 25 per cent greater than the minimum rates; gradually, however, the gap was widened, until maximum rates eventually became four times as high as minimum rates. The same trend is found in the maximum tariff schedules of Spain, Belgium, Norway, and Portugal. Countries employing general-and-conventional tariffs were also inclined to increase the padding in their general tariffs. Where a nation had previously been willing to reduce through bargaining a \$10 duty to \$8, it might consider that changes in fiscal needs or competitive conditions required that the minimum duty be advanced to \$10. But, suspecting that a \$2 reduction from a \$12 duty

<sup>4</sup>Exceptions to this equality of treatment are to be found in the trade between France and Portugal, 1891-1911, in that between France and Italy, 1888-1898, and for briefer periods in the trade between Austria and Serbia and in that between Turkey on the one hand and Greece and Bulgaria on the other. It should be noted, however, that these exceptions rested upon the absence of treaties or upon the absence of most-favored-nation clauses in the treaties. *Ibid.*, p. 7.



## 398 International Trade and Commercial Policy

would appear rather small to other countries in future negotiations, in view of the previous \$2 reduction from a \$10 duty, it would establish an initial rate of \$15, from which it would be quite willing to concede a \$5 reduction. Even if there were no inclination to increase the basic \$8 duty, the nation might consider that its bargaining power in future negotiations would be augmented if the general rate were advanced from \$10 to \$11, or even to \$12.

Another feature of European tariff bargaining in this period was the carrying on of negotiations by one state simultaneously, or in quick succession, with a considerable number of states. Such simultaneous negotiations were made possible by fixing the duration of all a nation's treaties so that they would expire, or be subject to denunciation, at the same time. Each state thus had a free hand when the next period of bargaining rolled around; and the danger that any state might delay entering upon negotiations in the hope that it might, because of unconditional most-favored-nation treatment, secure for itself the concessions which resulted from the negotiations between other states, without giving up anything itself, was minimized. All the important commercial treaties between European countries consequently tended to expire about the same time. For example, Germany postponed putting into effect her tariff of 1902 in order that new conventions might be negotiated; other countries followed her example. The result was that in 1906 a whole new series of treaties became effective that were intended to stabilize the European tariff system on a new basis until 1916.

Tariff bargaining was resumed after the first World War, but the treaty network assuring equality of treatment has never since attained the comprehensiveness of the pre-1914 period. This failure of tariff bargaining was due in part to the number of new states to which the Treaty of Versailles gave birth and to the new and rapidly changing economic conditions; but it was due even more to policy changes which resulted in the wider uses of quotas, prohibitions, exchange control, and bilateral clearing agreements—restrictive devices which had not been covered by the most-favored-nation clause. Since the early 1930's the principle of equality of treatment in commercial policy has had a rough road to travel.

Aggressive tariff bargaining has in its general effects been harmful. Bargaining tariffs have tended to increase rather than to reduce

the obstacles to international trade. Although bargaining tariffs are, in general, concessional in form, they are combative in spirit. General, or maximum, rates have been set high in the belief that the heavier the penalties a nation is in a position to impose upon the commerce of other nations, the stronger is its bargaining position. The reduction of these high rates has afforded other countries no easier access to the domestic market than they would have enjoyed under a single-schedule tariff designed simply to meet what were judged to be the industrial and fiscal needs of the country. Since the 1860's tariffs have moved upward undeviatingly, despite widespread bargaining; and this competitive bidding-up of tariff rates has never been completely undone by subsequent negotiations. General rates have in some instances evaded any conventional reduction; in other instances, negotiations have completely broken down, leaving the exports of certain countries subject to maximum duties. And underlying most tariff-making and tariff negotiations has been the almost universal belief that tariff reductions are injurious to the country making them, anyway.

Another shortcoming of tariff bargaining is that it has at times introduced uncertainties into trade and caused serious commercial dislocations. Unless tariffs are revised and new treaties negotiated before old treaties expire, a period of instability and sudden changes follows. Where haggling is long drawn out, trade is for a long while subjected to rates considerably higher than can be fiscally or economically justified. When negotiations do not succeed, duties remain in effect that are higher than intended, that cause discriminations among the products of different countries, especially where the most-favored-nation clause is not in full and unconditional operation, and that force trade into uneconomic channels.

Finally, where tariff bargaining is widely practiced, countries which have no desire to indulge in bargaining may nevertheless be forced to adopt the practice. This situation is ably described by the following statement of the Swiss Federal Council in justification of the introduction of higher duties into the Swiss tariff of 1921:

Foreign countries oppose to us tariffs whose rates are, so to speak, much higher than ours. When we ask 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

## 400 International Trade and Commercial Policy

measure, from a general tariff but which cannot be made from a working tariff! While the negotiators of the foreign state finally understand our particular situation and take our working tariff for what it is, that is to say for a minimum tariff, the public opinion and the 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.<sup>5</sup>

### AMERICAN EXPERIENCE WITH TARIFF BARGAINING BEFORE 1934

Bargaining tariffs did not play a major role in American tariff history before 1934. One reason for this lack of interest in bargaining tariffs was that American constitutional law and political organization place severe handicaps upon successful diplomatic negotiations. Treaties may be negotiated by the President, in fact the initiative in such matters must be taken by the President; but treaties negotiated by the President do not assume the sanction of law until they have been ratified by two-thirds of the Senate. Unless the President's party commands a substantial majority in the Senate, or unless his treaty commands widespread popular support, the treaty may easily fail of ratification. Before 1922, at least twenty treaties failed to become law because of the Senate's refusal to ratify them. A much larger number became law only after material amendment had been made by the Senate; some of these amended treaties were approved by the President, the others were rejected.

Another reason why bargaining tariffs played such a minor role in American history prior to 1934 is that in the half-century before the first World War, when the European tariff structure was being built on trade treaties, foreign commerce played a relatively small part in the business life of this country. We were diverting our energies and capital to the development of our vast resources; consequently, our interest in tariff legislation lay chiefly in protecting our young industries from the competition of established industries abroad, rather than in trying to expand foreign markets for the products of our industries. Furthermore, the goods that we did export, primarily food-stuffs and raw materials, were in such active demand abroad that

<sup>5</sup> *Ibid.*, p. 12.

foreign tariff barriers on these products were either non-existent or were very low, and therefore caused us little concern. Our deeper concern over foreign tariff barriers since 1918 is to be explained in part by our rise to the position of one of the two greatest creditor nations in the world, and in part by the fact that today well over 50 per cent of our exports consist of manufactured and semi-manufactured goods, compared with less than 20 per cent in the 1880's; such goods must face the competition of third countries in foreign markets.

Even in the earlier period, however, when foreign markets were of less interest to Americans, the United States did engage in tariff bargaining on a limited scale. But American tariff bargaining and American reciprocity agreements in this period reveal no continuous or settled policy. Negotiations have at times sought special and exclusive concessions; at other times, equality of treatment. On occasion, the penalty method has been employed; at other times, the concessional method. Down to the first World War, the traditional American interpretation of the most-favored-nation clause was the conditional interpretation; after the war this was superseded by the unconditional interpretation. Today the United States has become the leading exponent of the unconditional interpretation of the most-favored-nation clause.

American experiments with tariff bargaining may be conveniently divided into (1) reciprocity agreements, and (2) agreements authorized under general legislation.

#### (1) RECIPROCITY AGREEMENTS

It will be remembered that the special concessions granted in reciprocity agreements are not extended automatically, generally, and freely to third states. The most important reciprocity agreements concluded by the United States were those with Great Britain for Canada in 1854, with Hawaii in 1875, and with Cuba in 1903. The only one of these agreements which is still in existence is the one with Cuba. The Canadian treaty was denounced by the United States in 1866, while the Hawaiian treaty was terminated by the annexation of Hawaii in 1898 and its assimilation into the American tariff system in 1900.

*Canada.* The reciprocity treaty of 1854 with Canada, the only

## 402 International Trade and Commercial Policy

agreement of its type between the two nations prior to 1935, despite their geographical propinquity and the complementary nature of their economies, was the direct outcome of the repeal of the English Corn Laws in 1846. By this act of the British Parliament, Canada received tariff autonomy, but at the same time her exports were deprived of preferential treatment in the markets of the mother country. As a result, Canadian statesmen and businessmen sought closer commercial relations with their neighbor to the south. In the United States, times were prosperous and protectionist sentiment was at a low ebb, so that there seemed little to fear from Canadian competition.

The Treaty of 1854 provided for the mutual enjoyment of the Atlantic coast fisheries, a matter which had long been a constant source of controversy between the two countries, and for reciprocal use of canals and waterways. With respect to commerce, it established virtually free trade in the natural products of the two parties. The term of the treaty was fixed at ten years. At the end of this period notice of abrogation was given by the United States, and the treaty terminated in 1866.

There seems little question but that both countries benefited by the treaty, as trade between them increased three-fold in the eleven-year period. Abrogation was motivated more by political than by economic considerations. Deep resentment against Canada had been aroused in the northern United States by the activities and pronouncements of Canadians who sympathized with the Confederacy. The demands of domestic fish, coal, and lumber interests for protection and the governmental need of revenue also encouraged American abrogation. Canadian opinion favored the continuation of reciprocity, and repeated efforts were made by Canadian statesmen for renewal of the agreement—without success.

The United States renewed reciprocity negotiations with Canada again in 1910. A Canadian reciprocity agreement seemed necessary at that time if the application of the penalty duties of the American Tariff Act of 1909 to Canadian goods was to be avoided; it was feared that the preferential duties which Canada granted to imports from Great Britain might be held unduly discriminatory against American commerce and might be considered a cause for the im-

sition of penalty duties. An agreement decidedly favorable to Canadian trade was drawn up and was ratified by Congress in 1911. The Canadian electorate, however, rejected the agreement. Fear of concealed annexionist motives and loyalty to the mother country apparently outweighed economic considerations with the Canadian people.

*Hawaii.* By the terms of the commercial treaty of 1875 with Hawaii each country agreed to admit various products of the other free of duty. The chief Hawaiian industry to benefit was sugar growing. To the United States, the commercial importance of the treaty was never great.<sup>6</sup> Her gain was rather of a political and military nature. The Hawaiian government agreed not to make any territorial grants or leases of ports to other powers nor to grant to other countries duty reductions similar to those granted us. When the treaty was renewed in 1885, the United States was granted a naval base at Pearl Harbor.

Reciprocity was the prelude to annexation. The placing of sugar on the free list by the United States in 1894 caused much distress among Hawaiian sugar planters, whereupon they urgently insisted upon annexation. When the Spanish-American War broke out and the American fleet crossed the Pacific, the Hawaiian government threw open its ports to American use—and annexation inevitably followed.

*Cuba.* The Cuban reciprocity treaty of 1903, like the treaty with Hawaii, is an exclusive agreement in whose benefits no third country can claim to participate, even by virtue of an unconditional pledge of most-favored-nation treatment. Like the Hawaiian treaty, its terms reveal the action of powerful political influences. Its political background is the Spanish-American War, as a result of which it was felt that we had acquired a definite moral responsibility for the future of Cuba. The United States was also deeply concerned

<sup>6</sup> The free admission of Hawaiian sugar into the United States did not inure to the advantage of the American consumer. Since duties were collected on sugar imports from all other countries, and since Hawaii never supplied more than one-seventh of the total American imports, the full-duty sugar fixed the price in the American market, and the remission of the duty amounted to a present to Hawaiian sugar growers. Bidwell, *Tariff Policy of the United States*, p. 23.

## 404 International Trade and Commercial Policy

over the strategic location of the island at the entrance to the Gulf of Mexico; as a consequence, she established a virtual protectorate over the island by the Platt Amendment of 1901.

In the commercial treaty both parties granted concessions in tariff rates. The United States granted to Cuba preferential rates which were 20 per cent lower than her general rates; Cuba reciprocated by granting to the United States duty reductions varying from 20 to 40 per cent. Both countries also agreed that, if in the future either should place duties on articles then on the free list, such duties should not be applied to the trade between Cuba and the United States.

The economic benefits which the United States has derived from the reciprocity treaty have been modest. For several years after the signing of the treaty, and for a few years after the first World War, American exports to Cuba grew more rapidly than exports to other North and South American markets. In other years, however, they resumed their pre-treaty position.

The Cuban sugar industry was the chief beneficiary of the preferential duties. Cuban exports of sugar jumped from an annual average of 1,729 million libras in 1900-1903 to 4,217 millions in the period 1910-1914. Since the United States continued to import substantial amounts of sugar from Java during the ten years after 1903, and since Javanese sugar paid the full duty, Cuban sugar producers received a virtual bounty from the United States. This preferential price stimulated the expansion of the Cuban industry—financed chiefly with American capital and organized by American businessmen—to such an extent that today no full-duty sugar is imported into the United States. The effective rate of duty is that imposed on Cuban sugar. It seems doubtful, however, that the one-half-cent-a-pound preference which Cuban sugar now enjoys in the American market is responsible for keeping other foreign sugars out. The nearness of Cuba to the United States and its advantages in sugar production would probably defeat competition from other foreign sources even without the benefit of the tariff preference. Cuban sugar producers are today more seriously concerned over the absolute height of the American tariff and the quota, which together are nurturing a domestic industry in the United States, than over the amount of the duty preference.

## (2) AGREEMENTS AUTHORIZED UNDER GENERAL LEGISLATION

American tariff bargaining before 1934 was not confined to seeking exclusive agreements with other countries; several American tariff acts contained provisions for the exchange of mutual concessions in which any number of countries might participate. These bargaining provisions were in some cases designed to secure special concessions; in others, they sought equality of treatment. The bargaining provisions of some acts offered foreign countries concessions, while the provisions of other acts held out the threat of penalty rates.

The growth of large-scale manufacturing in the United States in the 1880's aroused considerable interest in the development of export markets. The rise of a new protectionist movement in European countries at that time unfortunately destroyed any hope that tariff bargaining could open up worth-while markets across the Atlantic. Consequently, we turned our attention to the possibilities of securing reductions in the tariffs of Latin American countries. Substantial obstacles, however, dimmed the prospects of successful tariff negotiations with our southern neighbors. We had nothing in the way of concessions to offer several of the Latin American countries that had important markets to offer us—e.g., Mexico, Argentina, Brazil, and Chile; their exports consisted primarily of agricultural products which were directly competitive with our own. Furthermore, the growing political strength of the American farmer had become a factor to be reckoned with. Finally, the chief imports into the United States from these states—coffee, sugar, molasses, and hides—were at that time on the free list.

*Penalty Duties.* In order to provide the United States with an effective bargaining weapon, the Tariff Act of 1890 set forth its bargaining proposals in the form of penalty duties, not concessions. The President was empowered to impose penalty duties on the four commodities enumerated above, and tea, coming from any country whose import duties on our products he deemed to be "reciprocally unequal and unreasonable." In other words, any country that expected to continue to have its exports of coffee, sugar, molasses, hides, and tea admitted into the United States duty free must not only not discriminate against American exports; it must also reduce



## 406 International Trade and Commercial Policy

its own import duties on our exports from levels which we deemed to be too high—although we considered it nobody else's business how high we might choose to set our own tariffs.

Agreements with eleven nations were concluded under the Act of 1890; these eleven foreign nations made reductions in their tariffs in return for our promise not to impose penalty rates against their exports. The repeal of these reciprocity provisions by the United States in 1894 engendered considerable ill feeling, with the result that some states withdrew the concessions previously made while others adopted retaliatory measures. Penalty duties were actually applied to imports of coffee, hides, sugar, and molasses from Colombia, Venezuela, and Haiti, because of the failure of these countries to reduce their duties on American products.

The appearance of discriminations against American exports in the tariffs of certain European nations led to the inclusion in the Tariff Act of 1897 of another provision for the application of penalty duties, this time to coffee, tea, vanilla and tonka beans imported from countries treating our commerce "unjustly and unreasonably." The penalty duties of this act were less effective than the similar provisions of the Act of 1890 had been because sugar and hides had been placed definitively on the dutiable list and hence were unavailable for bargaining. The only important "success" was the treaty of 1904 with Brazil, by which for 20 years she accorded our commerce preferential treatment in the face of our threat to impose an import duty of \$0.03 a pound on her coffee.

The threat of imposing penalty duties in order to secure special and exclusive concessions has, on the whole, met with negligible success. With the exception of the concessions from Brazil, no significant exclusive concessions were obtained, in spite of our strong economic position. On the contrary, such provisions frequently led to misunderstanding and friction with third countries, and on occasion to retaliation.

Some American tariff acts have held out the threat of penalty duties as a means of securing merely equal treatment for our commerce. In the acts of 1894, 1897, and 1922, provision was made for imposing new duties, or raising existing duties, on specified articles imported from countries which levied duties, or charged higher duties than we did, on the following articles: salt, petroleum, auto-

mobiles, bicycles, brick, calcium acetate, cement, coal, and gunpowder. The 1922 act empowered the President to raise by 50 per cent the duties on any or all products of a country found to be discriminating against our commerce, and to enforce a total prohibition against that country's products if the higher duties proved insufficient to bring about a removal of the discriminations.

*Concessions.* The Act of 1897 carried, in addition to the provisions for penalty duties, two separate provisions for granting concessions. The first provision offered reduced rates on argols, brandies, champagnes, wines, paintings, drawings, and statuary to any country which would offer "reciprocal and reasonable concessions." Agreements made under this section did not require ratification by the Senate. Argol agreements, as they were called, were concluded with nine nations, eight of which conceded to the United States most-favored-nation treatment. France, the sole exception and the country to which the American concessions were of chief importance, removed various discriminations against American products.

The other provisions of the Act of 1897 authorized the President to conclude with other nations commercial treaties of limited duration for the exchange of mutual tariff concessions. The President was authorized to reduce American duties by as much as 20 per cent; he could also transfer goods from the dutiable to the free list, in case no comparable articles were produced in the United States. Commercial treaties based on these concessions—known as Kasson treaties, from the name of the American commissioner who negotiated them—were negotiated with seven states. But no one of them ever went into operation. Unlike the argol agreements, these Kasson agreements had to be ratified by the Senate and approved by Congress, and business interests were able to bring enough pressure to bear upon Congress to block ratification. The experience with the Kasson treaties illustrates the futility of tariff bargaining where particular agreements, and especially specific duty reductions, have to be ratified by Congress.

A new bargaining device was incorporated into the Tariff Act of 1909, which had as its objective, not exclusive concessions, but the elimination of discriminations against and the establishment of equality of treatment for American products. This device was the double-schedule tariff. The stated tariff rates were declared to be

## **408 International Trade and Commercial Policy**

the minimum rates. Penalty rates, which were fixed by adding 25 per cent of the value of the articles imported to the minimum rates, were to be levied on goods coming from countries which "unduly discriminate" against the United States. Negotiations under this act for the removal of discriminations against American commerce were only partially successful. The maximum duties were applied against no country, even though France, Italy, and Germany continued to subject certain imports from the United States to unequal treatment.

The Underwood Tariff Act of 1913 empowered the President to negotiate trade agreements with foreign nations "wherein mutual concessions are made looking toward freer trade relations and further reciprocal expansion of trade and commerce." Such agreements were to be submitted to Congress for ratification or rejection. President Wilson made no use of the bargaining powers granted by this act; the outbreak of war in 1914 upset trade relations and prevented further experimentation with tariff bargaining.

The shift in American bargaining objectives from special concessions to equality of treatment runs approximately parallel to the shift in our interpretation of the most-favored-nation clause from the conditional to the unconditional. The abandonment of the quest for exclusive concessions is evident in the Tariff of 1909, and the principle of equality of treatment is explicitly stated in the Act of 1922. In an exchange of notes with the Brazilian government in 1923, the American government voluntarily released the former from the obligation of maintaining the preferences first granted us in the treaty of 1904, which were now recognized as being inconsistent with the newly announced policy of equality of treatment and the unconditional version of the most-favored-nation clause. In 1925, for the first time, an American treaty (with Germany) contained a clear cut statement of the unconditional most-favored-nation clause. Since that time, the United States has been an ardent supporter of the unconditional interpretation, which has been a basic principle of all agreements signed under our Reciprocal Trade Agreements program.

### **THE RECIPROCAL TRADE AGREEMENTS PROGRAM**

The Reciprocal Trade Agreements program of 1934 represents the readoption of a policy of tariff bargaining by the United States, but

a bargaining policy sounding a note refreshingly different from the clamor for exclusive concessions which characterized the bargaining features of the Tariffs of 1890 and 1897. The Act of 1934, passed as an amendment to the Tariff Act of 1930, frankly recognizes that imports and exports are not two separate and unrelated branches of trade, but are rather inextricably interdependent members of a single organism. It concedes that reductions in duties are not necessarily injurious to domestic production and employment, and professes the willingness of the United States to grant reductions from its effective level of duties in exchange for similar reductions by foreign countries.

*Background of the Act.* The Act of 1934 was an inevitable reaction to the failure of the policy of high protection that reached its climax in the Hawley-Smoot Tariff of 1930. The three years following the passage of that ill-fated act witnessed a precipitous and drastic decline in world trade. From a turnover value of \$68,152,300,000 in 1929, world commerce declined to \$24,000,000,000 in 1933. The share of the United States in this commerce declined in the same period from \$10,050,840,000 to \$3,443,405,000. Moreover, this decline in the value of trade represented a decline in the physical volume of trade as well as in the prices of the goods entering international trade. To attribute this shrinkage in world commerce to the American tariff policy alone is, of course, unjustifiable. Trade restrictions abroad had multiplied, international investment had broken down, and deflation and depression had fastened their grip upon the whole world. Nevertheless, it may be fairly said that our high tariff barriers were important contributors to the debacle, and later acted as impediments to world trade recovery. Many of the trade restrictions of foreign countries were imposed in direct retaliation against our prohibitive rates, while the severe and sudden restriction of our market caused other countries hastily to erect barriers in defense of their domestic economies.

The decline in our exports wrought severe hardships upon the American economy, particularly upon agriculture, which relied heavily upon foreign markets. Furthermore, the shutting-out of international trade did not result in an increase in our domestic trade. As Secretary of State Cordell Hull pointed out, "Instead of increasing as our foreign trade decreased, our domestic trade decreased at

## 410 International Trade and Commercial Policy

a similar huge rate.”<sup>7</sup> President Roosevelt stated in his message to Congress on March 2, 1934, that heart-breaking adjustments in our export industries would be necessary if the shrinkage of American foreign commerce remained permanent. It was widely realized, too, that unless foreign purchasing power were revived, foreign debtors would be unable to service their debts to us, to say nothing of ever repaying the billions of principal that they had borrowed from us. While it was admitted by the proponents of reciprocal agreements that no concessions that amount to anything can be entirely painless, it was staunchly protested that carefully considered concessions would benefit the country as a whole.

Since the incoming Democratic administration was committed to lower tariff rates anyway, and since American successes with tariff bargaining in the past had not been impressive, it may be wondered why tariff bargaining was resorted to again. Why not simply pass a new tariff act embodying generally lower duties? Such a procedure seemed impracticable for three reasons. For one thing, the Democratic party was no longer the staunch defender of trade liberalism which it had been in 1913: protectionism had pierced its ranks at many points. There was therefore little prospect that the reopening of the entire tariff to revision on the floors of Congress would produce any substantial reductions in duties. On the contrary, experience furnished ample ground for the belief that such a course would only encourage log-rolling, which would ultimately produce higher, not lower, rates. In the second place, while a judicious unilateral lowering of duties may be made with a minimum of hardship at a time when productive factors are fully employed, the effects of duty reductions may be more serious when unemployment is widespread. A lowering of our tariff wall would, to be sure, cause imports into this country to increase and would thus place in the hands of foreign purchasers greater purchasing power with which to buy larger quantities of our export surpluses. But, if a time lag between the increase of imports and the consequential increase of exports eventuated, the spiral of deflation would be given added momentum, causing additional unemployment and a further reduction in production before any stimulation from increased exports was experienced. And the

<sup>7</sup> Quoted by Paul V. Horn, *International Trade, Principles and Practices*, p. 208.

eventual expansion of exports might well be insufficient fully to counteract this additional contraction. Finally, our own tariff walls were not the only obstruction to international trade. The widespread adoption of exchange controls and import quotas, the collapse of the most-favored-nation principle and its replacement by exclusive bilateral agreements, the prevalence of subsidies and dumping, and the spread of currency depreciation were even more formidable obstacles to the reopening of normal trade channels. Unilateral tariff reductions on our part would have left untouched this mounting mass of trade barriers that had been erected all over the world as a result of aggressive economic nationalism. If American export markets were to be rewon, some method of bringing about the simultaneous reduction of trade barriers at home and abroad had to be devised. The method chosen was that of international bilateral agreements for the mutual reduction of trade barriers.

*Purpose of the Act.* The purpose of the Act of 1934, as declared in the Act itself, was to expand ". . . foreign markets for the products of the United States . . . by regulating the admission of foreign goods into the United States in accordance with the characteristics and needs of various branches of American production so that foreign markets will be made available to those branches of American production which require and are capable of developing such outlets by affording corresponding market opportunities for foreign products in the United States. . . ." Specifically, it sought to lower tariffs throughout the world, to abolish import quotas—or at least greatly enlarge the quotas themselves, exchange controls, prohibitions, and exclusive bilateral agreements, and to extend the application of the unconditional most-favored-nation principle.

*Authority Granted to the President.* By the Act, the President was empowered to enter into reciprocal treaties with foreign countries for the purpose of establishing mutual trade concessions. He was permitted to lower, or raise, duties by as much as 50 per cent, but was explicitly forbidden to transfer dutiable commodities to the free list, or duty-free articles to the dutiable list. Agreements negotiated under the Act were to go into effect upon proclamation by the President; ratification by the Senate was not necessary. The Act denies the President the authority to "cancel or reduce, in any manner, any of the indebtedness of any foreign country to the United

## 412 International Trade and Commercial Policy

States.” The authority granted to the President in the Act was to terminate at the end of three years, but it was extended for three-year periods in 1937 and 1940, and again in 1943 for a period of two years. In 1945 this authority was renewed for another three-year period.

*Procedure.* The procedure for putting the new policy into effect is one carefully designed to give all interested parties a fair hearing. The whole program of preparing and negotiating trade agreements is supervised and energized by the Trade Agreements Committee, whose membership includes high officials of the State, Commerce, Agriculture, and Treasury Departments, the Tariff Commission, and the Agricultural Adjustment Administration. If the negotiation of a trade agreement seems to merit serious consideration, and if there is a likelihood that the foreign government concerned would be prepared to enter into negotiations upon the basis of equality of treatment in respect to all forms of trade control, a “country committee” is set up to make a preliminary report with recommendations. If, after a searching examination of this report, the Trade Agreements Committee is favorable to an agreement, and if the foreign government is prepared to negotiate on an unconditional most-favored-nation basis and to cease any discriminations against American commerce, public notice is given that negotiations for an agreement with that particular country are to be undertaken, and a list of the commodities upon which duty reductions are to be considered and sought is announced.

Hearings are then held by the Committee on Reciprocity Information, another interdepartmental committee, at which interested parties may express their views. The information gathered at these hearings together with a mass of other data prepared by the country and commodity subcommittees are subjected to a painstaking analysis occupying many months. From all this research, there finally emerge two schedules: a list of commodities upon which we intend to ask concessions of the foreign country, along with recommendations as to just what concessions should be requested—whether a tariff cut, a quota enlargement, a freeing from import restrictions, a binding of duty, or some combination of these—and the extent of each; and a list of concessions which we might consider granting. These two schedules, together with various general provisions de-

signed to prevent discriminations and safeguard the detailed concessions, must be finally approved by the Secretary of State and the President. These approved proposals then become the limits within which formal negotiations with the other country are carried on, with frequent reference back to the Trade Agreements Committee, the President, and the Secretary of State.

While we are in the midst of these hair-trigger negotiations, seeking to win an agreement of real profit to both sides, high-powered lobbyists make their voices heard throughout the country, using every device to prevent the giving of concessions in the particular commodities in which they are interested or to defeat or upset the agreement. Pressure is brought against members of Congress; Washington is deluged with inspired letters and telegrams. The country rings with the protests of special interests; unhappily, few seem sufficiently concerned to speak for the interests of the consumer or of the nation.<sup>8</sup>

After weeks, or even months, of bickerings, proposals, and counter-proposals, the trade agreement is at last ready.

*Most-Favored-Nation Clause.* The United States has insisted upon the inclusion of the unconditional form of the most-favored-nation clause in each of the thirty-two agreements with the twenty-eight nations with whom agreements have been concluded.<sup>9</sup> The concessions accorded each nation have been generalized to all nations which do not discriminate against our commerce. Thus does the United States affirm its policy of equal treatment. While third parties benefit from each concession granted in new agreements, the United States in turn profits from every duty reduction which nations having trade agreements with us accord to others.

<sup>8</sup> From Francis B. Sayre, *The Way Forward*, p. 95-96. By permission of The Macmillan Company, publishers.

<sup>9</sup> Up to March, 1946, agreements had been concluded with Cuba, Belgium, Luxembourg, Haiti, Sweden, Brazil, Canada, the Netherlands, Switzerland, Honduras, Colombia, Guatemala, France, Nicaragua, Finland, Costa Rica, El Salvador, Czechoslovakia, Ecuador, the United Kingdom (including Newfoundland and the British colonial empire), Turkey, Venezuela, Argentina, Peru, Uruguay, Mexico, Iran, and Iceland. A revised agreement with Canada was signed in 1938; two supplementary agreements with Canada and two with Cuba have also been signed. Today agreements are in effect with twenty-seven states; operation of the agreement with Czechoslovakia was suspended on April 22, 1939. Intentions to negotiate an agreement with Paraguay have been announced.



## 414 International Trade and Commercial Policy

Insistence upon the inclusion of the unconditional form of the most-favored-nation clause in every agreement is the means employed to guard against one of the principal pitfalls of reciprocal agreements, viz., the notion of a *quid pro quo* arrangement, whereby the volume of imports from a given country is limited to the value of our exports which that country is willing to accept from us. Such bilateral clearing agreements, widely developed by Germany in the 1930's, tend to destroy triangular trade, restrict international commerce, and divert world economic activity away from comparative advantages instead of towards them.

But the unconditional most-favored-nation clause has at the same time been one of the points of sharpest attack by critics of the Trade Agreements Act. The most frequent criticism of the unconditional most-favored-nation clause, viz., that it involves granting concessions to third nations for nothing, has already been answered. We do not extend trade agreement concessions to third nations without receiving something in return. Third nations secure these concessions only in return for their extending to us the benefits of concessions which they have granted, or may in the future grant, to all other nations. To state it differently, we give minimum tariff treatment and freedom from discrimination in return for minimum tariff treatment and freedom from discrimination. This guaranteed freedom from discrimination is of inestimable value to American exporters.

It has also been charged by critics of the new policy that the generalization to third countries of concessions granted to any country will destroy all possibility of further bargaining. Why should any country bargain with us if she will receive all the concessions that we grant to third countries, merely by virtue of her most-favored-nation guarantee, without conceding anything herself? This criticism would be unanswerable if all duty reductions were written into a single treaty. But this is not the case. In order to preserve our own bargaining power, we have adopted as a cardinal principle of our policy the rule of limiting the tariff reductions granted to any country to those articles of which that country is the chief source of supply. How effective this method can be, owing to the high degree of specialization in production in most countries, Dr. Benjamin B.

Wallace has convincingly pointed out.<sup>10</sup> Of the dutiable imports into the United States in 1931 from 29 countries that supplied 96 per cent of our dutiable imports, 71 per cent of each import, on the average, came from some one country, and only 29 per cent from all other countries. When general imports are broken down into more detailed import classes, moreover, it is found that each separate sub-item is imported almost exclusively from some one country. Therefore, it seems highly improbable that the new American tariff policy involves the gratuitous extension to third countries of concessions on even as much as 29 per cent of our imports. The percentage was, according to Secretary of Commerce Wallace, probably less than 20, and perhaps not much more than 10. In the long run, even these concessions can hardly be called gratuitous, for most countries will find that there are other commodities upon which they will desire duty reductions, and they will be willing to bargain for these additional reductions. The unconditional most-favored-nation clause thus does not preclude tariff bargaining; but it does pretty much restrict it to articles imported from one country.

*Duty Reductions and Our Policy of Protection.* In addition to the limitation of confining duty reductions in any single agreement to those commodities which are imported chiefly from the particular foreign country that is a party to that agreement, further limitations on duty reductions are observed in sympathy with our policy of protection. Rate reductions on articles directly competitive with domestic products are avoided, so far as possible. Where competitive products are involved, rate reductions are eased, in order to avoid any serious disturbance of domestic production and employment. The care and skill with which such of our trade barriers as were excessive and indefensible have been reduced without injury to domestic production and employment are attested by the widespread and increasing support which the program has elicited throughout the nation and by the relatively few complaints that have been made regarding particular tariff adjustments.

In some instances where American import duties have been lowered, the interests of domestic producers have been further safeguarded by limiting the amount of the article which may be im-

<sup>10</sup> "Tariff Bargaining," *Foreign Affairs*, Vol. XI (July, 1933), pp. 621-633.

## 416 International Trade and Commercial Policy

ported at the reduced duty. In the first agreement with Canada, for example, the duty on beef cattle weighing over 700 pounds was reduced from \$0.03 to \$0.02 a pound; but the reduction was limited to imports equaling three-fourths of one per cent of our average annual slaughter of cattle and calves. In the same agreement, the duty on cream was reduced from \$0.566 a gallon to \$0.35, subject, however, to an annual quota of one and a half million gallons, equal to about one-quarter of one per cent of our domestic consumption. Unlike the French import quotas of the 1930's, described in the next chapter, these quotas are intended to permit an increase in trade, not to diminish it.

While extreme caution in making concessions has been exercised by those entrusted with carrying out the Trade Agreements program, this has not prevented substantial and numerous reductions in duties. More than 1200 American rates of duty have been reduced, about one hundred more have been bound against increase, and numerous other items have been bound on the free list. Postwar nationalism had eased the task of tariff lobbyists to such an extent that duties had been raised to insensate levels and had been applied to goods which no consideration of national welfare could justify. Duties on many agricultural products of which we produced an exportable surplus were completely ineffective. Other goods which were not even produced in the United States and hence were not directly competitive with American industry—Brazil nuts, caviar, lentils, mahogany, certain kinds of works of art, lace machines, imitation precious stones, and many others—were given protection. Certain articles supplied almost wholly from abroad entered the privileged fold. Outstanding in this group was olive oil, which bore a duty of \$0.065 a pound—approximately 75 per cent ad valorem—despite the fact that in the period 1921–1929 from 97.1 to 99.0 per cent of all domestically consumed olive oil was imported. It is estimated that this duty alone cost American consumers nearly five million dollars in the nine-year period—to protect an industry with an investment of about one million dollars.<sup>11</sup> In the same category are many goods of which nearly the entire domestic consumption is produced at home, and only a tiny fraction is imported, e.g., corn,

<sup>11</sup> The duty on olive oil was designed to protect domestic producers of vegetable oils as well as olive-oil producers.

biscuits, certain photographic materials, cocoa, and chocolate—goods produced by domestic industries which are obviously well able to stand on their own feet. Finally, inordinately high duties—75 per cent, 100 per cent, and even more—on many goods raise grave doubts concerning the effectiveness of certain domestic industries and the justifiableness of continuing such heavy burdens on American consumers.<sup>12</sup> Such high duties, furthermore, encourage domestic monopolies. The opportunities for reducing rates with a minimum of disturbance to domestic industry were obviously vast.

*The Broadening of Most-Favored-Nation Treatment.* One of the most interesting innovations introduced by the Reciprocal Trade Agreements program is the rewording of the unconditional most-favored-nation clause to apply not only to tariffs but to the newer devices of trade strangulation as well. In the various agreements that have been signed, there is a fairly consistent, explicit provision for the application of most-favored-nation treatment to internal taxes imposed on any product of either country imported into the other, to existing import prohibitions or quotas and those which may arise, and to the allocation of exchange where exchange control exists. Since these newer forms of trade control have been extensively used to defeat most-favored-nation practice as it existed before the first World War, it has been necessary to construct a precise definition of the meaning of the principle in respect to these forms of control. The precise definition of equality of treatment with respect to import quotas and exchange control has presented difficulties. As applied to quotas and exchange control, most-favored-nation treatment has been defined to guarantee to the other country a share of the total available imports into the country employing such control, which shall be equivalent to the proportion of total imports furnished by the other country during some base period when no controls were in effect. The right to impose quotas on concession items has been prohibited, or strictly limited. In the case of countries that subject most of their imported articles to quotas, it has been neces-

<sup>12</sup> A few of the goods receiving very high duties under the Act of 1930 were: sugar, 152 per cent; tobacco, 45 to 152 per cent; clocks, 108 per cent; onions, 142 per cent; cigars, 76 per cent; watch movements, 89 per cent; china and porcelain, 84 per cent; carpet wool, 114 per cent; lace articles, lace (machine-made), and embroidered cotton, 90 per cent. Specific duties have been converted to ad valorem duties at 1931 prices.

## 418 International Trade and Commercial Policy

sary to insist upon minimum quotas of specified amounts, in order not only to remove discriminations against American products, but also to secure adequate concessions for reductions which we are prepared to grant. In order to guard against discriminations in *rates* of exchange, it has been the usual practice to provide that most-favored-nation treatment be observed in respect to rates of exchange and taxes or surcharges on exchange transactions. Finally, where either government establishes a foreign trade monopoly, it is usually agreed that, in making its foreign purchases of any product, such monopoly will be influenced solely by those considerations of price, quality, marketability, and terms of sale which would ordinarily be taken into account by a private commercial enterprise interested solely in purchasing such products on the most favorable terms.

*Escape Clauses.* The administrators of the program have had to face two other well-known pitfalls of tariff bargaining: the danger that reciprocity will lead to "bargaining" tariffs, i.e., that a country anticipating a reciprocal trade agreement will raise its tariff, so that when it is later reduced by a tariff agreement it will be as high, or nearly as high, as before; and the danger that national currency management will virtually cancel, or at least greatly modify, the concessions granted in reciprocal trade agreements. The first danger has been met by the unequivocal announcement to the world by the State Department that it will not enter into reciprocal trade agreements with nations which employ "bargaining" tariffs as a weapon of negotiation.

The second danger has been more difficult to cope with, and has led to the insertion of an escape clause in all American trade agreements. This clause usually provides that in the event that a wide variation occurs in the rate of exchange between the currencies of the two countries, as a result of exchange operations, the use of stabilization funds, devaluation, or other devices of currency management, "the government of either country, if it considers the change in rate so substantial as to prejudice the industries or commerce of the country, shall be free to propose negotiations for the modification of this Agreement or to terminate this Agreement in its entirety on thirty days' written notice." It is obvious that the failure

to achieve world monetary stabilization could cause the program to founder.

Another escape clause covers the possibility of a shift in trade, whereby a third country obtains the major benefit of a particular duty reduction, instead of the party to whom the concession was granted, and an unduly large increase in total importations occurs. To meet this eventuality, each agreement usually provides for the withdrawal or modification of the concession on any article or the restriction of imports through the imposition of a quota on any such article by either government. If the withdrawal of the concession or the imposition of a quota is unacceptable to the other nation, however, the latter has the right to terminate the entire agreement.

A third escape clause subserves the idol of nationalistic economic planning. Under the agreements, either country is left free to impose restrictions in connection with government measures operating to regulate the production, market supply, or prices of domestic articles. But if, after consultation, the governments fail to reach an agreement over the proposed restriction, the dissatisfied government may denounce the entire agreement on thirty days' notice.

Two other frequent causes of international discord are handled in a promising manner under the program. The application of any new interference with imports on sanitary grounds by either government shall first be the subject of mutual consultation. In case either government objects to the application of any sanitary measure by the other, a committee of experts may be appointed to consider the matter and make recommendations to the two governments. This clause provided the entering wedge for the agreement of 1941 with Argentina.<sup>18</sup> Unfair practices in international trade are also dealt

<sup>18</sup> The agreement with Argentina included a provision, not included in any preceding agreement, for a mixed commission consisting of representatives from each government, who will consult on all matters affecting the operation of the agreement. Another interesting innovation incorporated into the Argentine agreement is a provision specifying that a certain proportion of the full tariff reductions granted this country by Argentina will not become effective until Argentine customs revenue from imports again equals at least 270 million paper pesos a year, an amount which approximates the annual average customs revenue in the ten-year period, 1931-1940. Another provision sets up a special schedule of concessions granted by the United States on a list of products—including wines and liquors, Italian-type cheeses, macaroni and similar prod-

## 420 International Trade and Commercial Policy

with in the agreements; anti-dumping duties and prohibitions or restrictions relating to public security, prison-made goods, and the enforcement of police or revenue laws are exempt from the general provisions for lowering duties.

*Effects of the Trade Agreements Program.* The real purpose of the Reciprocal Trade Agreements is to increase the volume of trade. Does the record show that they have succeeded in doing so? While the outbreak of war in September, 1939, caused serious disruption of world commerce, enough agreements were in operation from the beginning of 1936 to the time the German army invaded Poland to indicate whether they had afforded any stimulation to trade. During most of the year 1936, nine trade agreements were in operation; for 1937 the figure had jumped to fourteen. Two additional agreements were in effect throughout 1938, while the Czechoslovakian agreement went into operation on April 16 of that year. During most of 1939 twenty agreements were in operation, including one with the United Kingdom and the British Colonial Empire. Trade statistics for these years tend to support the view that the Hull agreements have acted as an important stimulus to world trade recovery.

American trade with agreement countries between 1935 and 1939 increased more rapidly than trade with non-agreement countries. Average annual exports from the United States to countries with which agreements had been signed were 62.8 per cent higher in 1938-1939 than in 1934-1935, while the percentage increase in exports to non-agreement countries in the same period was only 31.7. The stimulus given American exports by trade agreements is also reflected in the sharper increase in the United States' share of the total imports of trade agreement countries than in its share of the total imports into other countries. The United States in 1933 supplied 12.2 per cent of the total imports into the sixteen countries with which trade agreements became effective before 1938; by 1938 the American share in the imports of these same countries had grown to 19.7 per cent. The United States' share in the imports of the twenty most important countries with whom no trade pacts

ucts, and sunflower oil—of which this country's main source of supply had been curtailed by war. These concessions may be modified or terminated by this country on six months' notice at any time after the war.

were in effect in 1938, on the other hand, increased in the same period only from 12.1 per cent to 14.5 per cent. Exports to the individual agreement countries, moreover, have in almost all cases shown greater rates of increase than American exports as a whole.<sup>14</sup>

These figures cannot, however, be interpreted as delineating precisely the influence of the trade pacts upon American foreign trade. Too many other variables are reflected in the trade statistics, variables whose effects cannot be isolated. Industrial recovery or recession, drought, and rearmament for war in certain of these years unquestionably exerted an important influence upon our foreign trade. Imports into the United States in 1937 from non-agreement countries, by way of illustration, showed a greater increase over the preceding year than did imports from trade-agreement countries. But 1937 was a year of sharp business recovery in this country and followed a year of serious domestic drought; the imports which increased most rapidly in that year were raw materials and food-stuffs, goods which came largely from countries with which no trade pacts had been made.<sup>15</sup> Exports statistics for 1937 were also distorted by heavy purchases of such war materials as steel scrap, petroleum products, cotton, and copper by Japan, a nation with which we had no trade agreement.

Despite the inconclusiveness of the trade statistics for the years from 1936 to 1939, there can be no doubt that the Reciprocal Trade Agreements program of the United States has on balance operated to reduce barriers to trade. Duties have been reduced on two-thirds

<sup>14</sup> See David H. Popper, "Six Years of American Tariff Bargaining," *Foreign Policy Reports*, April 15, 1940, and Francis B. Sayre, *The Way Forward*, Ch. XIV. Sayre cites examples to show that in many instances imports into trade-agreement countries of American products upon which duties had been reduced increased much more than total imports of American products into those same countries. This is, perhaps, to be expected. But the augmented purchasing power in the United States which people in trade-agreement countries acquire from larger American purchases abroad, the result of our duty reductions, may very well lead to much larger foreign purchases of other American goods upon which these countries have made no duty reductions.

<sup>15</sup> In 1936, however, imports from trade-agreement countries showed an increase of 25.4 per cent over 1935, compared to an increase of only 14.5 per cent for imports from non-agreement countries. The annual average imports from trade agreement countries for 1938-1939 were 21.6 per cent above 1934-1935, compared with an increase of only 12.5 per cent in the same period for imports from non-agreement countries.



## 422 International Trade and Commercial Policy

of the dutiable imports of the United States (1939 figures); on 68 per cent (by value) of the items affected, the reduction has amounted to the full 50 per cent permitted by the Act. These duty reductions by the United States have been purchased by foreign countries with duty reductions on their own imports. The American Trade Agreements program is the only device yet to appear that has had any significant success in loosening the cords of bilateralism, which were slowly strangling international commerce, and in liberating triangular trade.

The outbreak of war in 1939 interfered with the progress of the program, but it did not put an end to negotiations. Supplementary agreements were signed with Cuba and Canada in late 1939 and 1940, while new agreements have since been signed with several Latin American countries, Iran, and Iceland. Today the Hull agreements are the one liberal program which has proved its effectiveness in breaking the jam of trade restrictions and which promises to the independent nations of the world, large and small alike, access on equal terms to the markets and the resources of the postwar world, and all that that implies for the improvement of living standards. If the United Nations can agree upon the establishment of the proposed International Trade Organization, which was discussed at an international conference during the autumn of 1946, the task of reducing barriers to international trade may be assumed by an international body. Until such an organization is created, however, the type of bilateral agreement based upon the unconditional most-favored-nation clause that is provided by the Trade Agreements Act seems to offer the greatest promise for the restoration of a multi-lateral world trading system. Such a system of world trade is greatly to be desired. Chinese walls and strangulating tariffs can create hot-house industries—at the expense of the consumer. But they cannot possibly produce iron, coal, petroleum, tin, copper, and nickel in countries that do not possess natural deposits of such minerals, nor rubber, tea, and coffee in countries in the temperate zone, except at practically prohibitive cost. No great industrial nation today is or can be completely self-sufficient economically. Attempts to attain such sufficiency by a few have not only failed; they have brought down upon the whole world the horrors and wastes of war. A lasting peace cannot be attained unless commerce among nations is released from its shackles.

One other criticism of the Act must be briefly considered. It has been argued that the abandonment of the requirement that tariff agreements negotiated by the executive must be ratified by the Senate constitutes an autocratic method of tariff making; the American people have been urged to restore democratic processes in their tariff making by again requiring that no trade agreement can become law unless and until it has been approved by a majority of the Senate. It is true that the procedure set up by the Act lessens the lobbyist's opportunity to grind his own axe. But the national welfare has not suffered therefrom. The President's authority to reduce duties has been carefully circumscribed by statute. Full consideration has been given in negotiations to the effects of duty reductions upon employment and capital values, and every care has been taken to make sure that American industries are not wilfully injured. The Trade Agreements program, it must be emphasized, does not constitute an abandonment of the traditional American policy of protection; but it does make a start in lopping off the gross excesses which have grown up under that policy. The teachings of history raise grave doubts that any significant tariff reductions would ever be achieved if the reductions of particular duties were made dependent upon Congressional approval.<sup>18</sup>

If the program is to be criticized on general grounds, it must be not because it has gone too far, but because it has not gone far enough. In many instances the margin of protection remaining is still more than sufficient. One writer calls attention to the fact that in 1939 one-fourth of our dutiable imports were restricted by quota

<sup>18</sup> The reduction of duties by even the full 50 per cent permitted by the Act still leaves many duties very high. A few examples of such duties after reductions are presented in the following table:

	Ad Valorem Equivalents	
	Pre-Agreement %	Under Agreement %
Whiskey	133	66
Wrapper tobacco	114	75
Manganese ore	107	54
Certain high-priced wool fabrics	97-99	87-54
Certain cotton laces	90	60
Certain watch movements	85 and 75	51 and 54
Sugar, Cuba only (imports subject to quota, also)	61	37

Source: the United States Tariff Commission. Quoted by Popper, *op. cit.*, p. 32.

## 424 International Trade and Commercial Policy

limitation. He concludes that, "The trade agreements program did not introduce a free trade policy, or even a general low tariff policy, but a policy of altering tariffs to the degree necessary to get concessions for American exports without hurting domestic producers. This 'adjusted protectionism' differed from past American protectionist policy more in technique than in fundamental concept."<sup>17</sup> The failure of imports into the United States to respond more noticeably to the duty reductions granted by the agreements is the most disappointing result of the program. In 1938 and 1939 American imports amounted to scarcely more than two-thirds of our exports. If foreign markets for American exports are to be regained and expanded, if interest and dividend payments on our growing foreign investments are to be maintained, and if the repayment of many billions of dollars of debts owed us by foreigners is to be realized, then American imports must expand, and expand more than exports.

*Amendment of 1945.* This need for the further encouragement of imports into the United States was given recognition in the 1945 amendment to the Act. This amendment seeks to strengthen the bargaining position of this country by permitting tariff reductions of as much as 50 per cent of the rates in effect on *January 1, 1945*, instead of basing such reductions on the 1934 rates. This change was advocated on the ground that the authority of the government to grant concessions within the limits set by the original Act had been nearly exhausted in agreements with some of the largest foreign purchasers from the United States, such as the United Kingdom and Canada. Tariffs had already been reduced by the maximum of 50 per cent on many commodities that would be sold in this country, so that the future bargaining power of the government had been weakened. If such countries, and other countries with which future agreements might be anticipated, are to be expected to make further reductions in their tariffs, the United States must be in a position to grant reductions beyond the 50 per cent provided in the Act of 1934. The effect of this amendment is to make possible total reductions amounting to as much as 75 per cent of the 1934 rates on a considerable list of commodities.

<sup>17</sup> William Diebold, Jr., *New Direction in Our Trade Policy*, Council on Foreign Relations, Inc., 1941, p. 23.

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## *Import Quotas*

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### THE GROWTH OF PROTECTIONISM

One of the outstanding characteristics of the Great Depression of the nineteen-thirties was the disruption of world commercial relationships. The breakdown of international economic equilibrium in 1929 caused a strengthening of the spirit of nationalism, accentuated the trend toward protectionism, and led to the introduction of new and more effective instruments of commercial policy. The resurgence of the spirit of nationalism and the revival of protection antedate, however, the world breakdown of 1929; their roots are to be found in the first World War and its aftermath. The United States, fearing the competition of products dumped on world markets by countries whose currencies had depreciated severely, raised import duties to new heights in her Emergency Tariff Act of 1921 and her Fordney-McCumber Tariff Act of 1922. The succession states of the old Austro-Hungarian Empire, seeking to secure their newly won freedom through a greater degree of national self-sufficiency, closed long established trade channels by her erection of prohibitive tariffs. Even free-trade Britain took a first step toward a policy of protection by the adoption of the McKenna Duties in 1915 and the enactment of the Safeguarding of Industries Act in 1921; the McKenna Duties were designed to promote the more effective prosecution of the war, while the Safeguarding of Industries Act was intended to provide greater national security by fostering domestic "key" industries. In France, the removal of existing import prohibitions was long delayed as a result of the economic and mone-

tary troubles of the early postwar period and the desire to protect industry and agriculture during the period of transition, although the French government surrendered its power to proclaim *new* import prohibitions in 1920 and the country eventually returned to the normal tariff regime of the prewar years. Postwar duties, however, attained levels much higher than prewar duties had. Most countries of the world adopted similar protective policies. Monetary stabilization by England in 1925 and by France in 1927 and returning world prosperity brought some relaxation of the protectionist controls imposed during the early twenties. But the vigor of the spirit of nationalism prevented the restoration of the relatively liberal trading policies of the prewar period.

Although drastic currency depreciation caused several European countries to establish import quotas, impose certain forms of exchange control, and even prohibit the importation and exportation of certain goods, customs duties nevertheless remained the chief means of providing protection for national industries in the decade of the twenties. During the decade between the Wall Street crash of September, 1929, and the declaration of war by Great Britain and France ten years later, however, the technique of trade restriction was radically altered. Tariffs were, to be sure, still widely used, and rates were continually being raised. Hardly had the depression set in, for example, when the United States passed the Hawley-Smoot Tariff of 1930, which raised many duties above even the high levels set by the Act of 1922. Our lead was quickly followed by numerous other countries; foreign nations raised their tariffs partly in retaliation against our duty increases, partly for the purpose of protecting their domestic economies from the ravages of depression. Great Britain completely abandoned her decades-old free-trade policy in 1931 and adopted a general protective tariff. But, despite the prevalence of formidable tariff walls, the chief reliance for protecting national industries was no longer placed on tariffs. Resort was had over a wider and wider area to import quotas and exchange control, devices which human ingenuity, after some experimentation, elaborated into tools of the utmost effectiveness. Country after country adopted some form of one or the other or both, and the range of commodities and transactions affected grew until one writer was compelled to conclude in 1938, "World trade has become enmeshed

## 428 International Trade and Commercial Policy

in so incredibly complex a network of restrictions that it is a wonder so much remains."<sup>1</sup>

The introduction of import quotas and exchange control profoundly altered the traditional economic relationships between nations and led to the creation of yet another form of control—the exclusive bilateral agreement. These bilateral agreements not only tended to restrict the volume of world trade; they tended to destroy multilateral trade and force trade into bilateral channels. The strictly bilateral trade (imports balancing exports in each direction) of a group of nations whose foreign trade accounted for approximately three-fourths of total world trade increased from 71.7 per cent of their total trade in 1929 to 74.2 per cent in 1935, while strictly triangular trade declined from 15.5 per cent of the total to 13.8 per cent in the same period.<sup>2</sup> Like import quotas and exchange control, the bilateral agreement was widely adopted and early became an arrangement of infinite complexity. It eventually became the basis of practically all German foreign trade. Never since the days of rampant mercantilism had trade regulations in peacetime resembled so closely the measures that are common in time of war as they had by 1936.

The intensification of protectionism after 1929 was the direct outgrowth of the world depression. The continued competition of imported goods offered at lower and lower prices was not to be tolerated while domestic unemployment was increasing, production shrinking, and profits vanishing. In the general price decline, agricultural prices were hit the hardest. The precipitous decline in the prices of raw materials and foodstuffs forced nations whose exports consisted largely of agricultural products and nations a large percentage of whose population was engaged in agricultural pursuits to take drastic measures to curtail imports. The former sought through such measures to improve their balance of international payments and to maintain the stability of their currencies; the latter strove to prevent any further recession in the level of domestic economic activity. The difficulties of agriculture did not begin in 1929; they had

<sup>1</sup> From P. T. Ellsworth, *International Economics*, p. 380. By permission of The Macmillan Company, publishers.

<sup>2</sup> The remainder of the total is accounted for by balances of total trade. League of Nations, *World Economic Survey*, 1935–1936, p. 182. The reference contains an explanation of the computation.

their roots in the first World War. Agricultural production had expanded greatly in the new world during the war in response to the abnormal wartime demand, and production in the western hemisphere failed to contract readily as agricultural production in Europe revived after the cessation of hostilities. As a consequence, nearly all western nations had to face an "agricultural problem" from 1925 on. Diminished industrial production and reduced incomes after 1929, which resulted in a smaller demand for agricultural products, merely accentuated maladjustments which had already begun to plague agriculture. In many European countries, e.g., France, the preservation of national agriculture meant much more than the loss of agricultural capital, which a free-trade policy would have entailed. The most stable and conservative, as well as the most powerful, element of society in such countries was the peasantry, who owned land in small parcels and whose entire lives, hard but rewarding, were rooted in the land. The disorganization of the national market by imports of cheap foodstuffs would have destroyed the security of this class and threatened the entire social structure with disorder and chaos.

Another major economic change that caused deep distress among debtor countries—and many agricultural nations were international debtors—was the almost complete cessation of international lending. The countries of central and southeastern Europe were especially hard hit, for not only were they deprived of the inflow of capital funds to which their economies had become accustomed, but they also had to contend with a sudden withdrawal of foreign funds, as well as with an expatriation of national funds. The United States must bear a considerable share of the blame for this disruption of the flow of international capital. During the postwar decade, this country became a large net exporter of capital; our annual net exports of capital averaged approximately \$500 million from 1919 to 1929. The frantic speculation in securities in 1928 and 1929 attracted to New York a large volume of foreign funds, which in 1929 largely offset our capital exports, and thus sharply reduced our *net* capital exports. In 1930 net capital exports practically vanished, and in the years following the net capital flow was toward the United States.

The virtual cessation of American capital exports immediately affected the entire structure of war debts and reparations. The pay-



## 430 International Trade and Commercial Policy

ment of war debts among the former Allies—the major part of which was ultimately paid to the United States—rested largely upon the payment of reparations by Germany. But Germany's ability to make payments on reparations account had, in turn, depended upon loans from the United States, for rising trade barriers had prevented the necessary expansion of German exports. Thus, the cessation of American capital exports impaired Germany's ability to pay reparations, caused the whole structure of reparations and war debts to crumble, and subjected national economies and balances of payments to additional strain.

The event that finally drove many countries to adopt a policy of drastic protection was the abandonment of the gold standard by Great Britain in 1931 and the resultant depreciation of sterling. Following the stabilization of the pound in 1925, the maintenance of a high bank rate by the Bank of England had attracted large short-term balances to London. Large-scale withdrawals of these foreign balances during the international banking crisis of the summer of 1931, precipitated by the failures of the Austrian *Creditanstalt* and the German *Nationalbank*, led to the rapid depletion of the Bank of England's gold reserve and the exhaustion of large credits which the Bank of France and the Federal Reserve Bank of New York had extended to the Bank of England. In September, it was decided to abandon the attempt to meet obligations in gold. Sterling thereupon depreciated sharply, and by December the pound had declined below \$3.50, compared with a gold parity of \$4.8665. Great Britain's departure from the gold standard induced many important suppliers of raw materials and foodstuffs to follow her example, since she was a quasi-monopolistic buyer of their products. This widespread currency depreciation exerted strong deflationary pressure upon the price levels of countries which chose to remain on the gold standard at the predepression parity, including the United States and members of the so-called "gold bloc"—France, Belgium, the Netherlands, Switzerland, Germany, and Italy.

Debtor countries, gold-bloc countries, agricultural countries all experienced rapidly deteriorating balances of payments. Heavy fixed debt payments, shrinking exports and declining prices of export goods, and annoyingly inflexible imports drained off gold reserves at a pace which threatened their quick exhaustion, or, if the gold

standard had already been abandoned, caused alarming currency depreciation, with its threat of internal inflation. Gold-bloc countries, in addition, experienced an actual increase in their imports of many goods, particularly foodstuffs, at steadily declining prices. Imports of food products into France, to illustrate, jumped from 67 million quintals in 1929 to 91 million quintals in 1931; imports of meat increased in the two years 300 per cent in quantity, dairy products 100 per cent, fresh fruits 65 per cent, and cereals 60 per cent. French import prices had fallen in 1932 to 55, based on 1927, compared with 94 for 1929; German import prices declined to 50 in 1932, compared with 101 in 1929; and United States import prices fell to 42 in the latter year, compared with 92 in 1929.<sup>3</sup> The decline in import prices caused general price deflation, increasing unemployment, and diminishing production. It was for the purpose of mitigating such intolerable conditions as these that nations turned despairingly first to higher tariffs, then to import quotas and exchange control, and eventually to bilateral barter agreements.

With this brief survey of the conditions which led to the adoption of the new instruments of commercial policy, we may now turn to an examination of their nature and effects. Import quotas will be examined first.

### IMPORT QUOTAS

An import quota involves a limitation on either the value or the quantity of a designated commodity that may be imported into a country within a given period of time. Ordinarily, a restriction upon the *quantity* of an import is meant when reference is made to an import quota. For example, a country might decide to limit imports of sugar to one million tons a year. Once this quantity has been admitted, no more sugar may be imported until the next year. The quota is one million tons a year.

The import quota should be distinguished from the tariff quota, on the one hand, and from the licensing of imports, on the other. Once the import quota is filled, no further imports of the specified commodity are permitted. The tariff quota, in contrast, permits imports in excess of the quota. But only the quota may enter duty-free, or at a special low rate of duty; all imports in excess of the quota

<sup>3</sup> League of Nations, *World Economic Survey*, 1932-1933, p. 59.

## 432 International Trade and Commercial Policy

must pay a duty, or a rate of duty higher than the special rate. Under the Canadian Reciprocal Trade Agreement of 1935, for example, the United States allowed 250 million feet of Douglas fir and western hemlock to enter the country annually from Canada at a reduced rate of \$0.50 a thousand board feet; but *all* imports of this lumber *in excess of* 250 million feet had to pay the regular rate of \$1.00 per thousand feet. No limit was set to the quantity that might enter at the higher rate.

Import-licensing schemes require importers to obtain licenses from some governmental authority before they are permitted to import. With this control over imports, the government is obviously in a position to restrict the quantity of imports; such restriction is, in fact, the common purpose of establishing licensing systems, although licenses are sometimes required in order to make sure that imports of a given commodity meet certain qualitative standards. Licensing systems differ from quotas, however, in that the quantity of imports permitted is not specified in advance; each transaction is considered by itself. Frequently, the issuance of licenses is made an integral part of the administration of quota systems. Both quota and licensing systems are invariably utilized to restrict the quantity of imports to an amount less than that which would have entered the country in the absence of control.

*Extent of the Quota System After 1930.* The import quota is not a new instrument of commercial policy. It was used extensively during the period of mercantilism, and its use was continued in many instances into the early years of the nineteenth century. After the middle of the century, however, the import quota largely disappeared, only to be revived during the first World War, mainly in the form of licensing systems. Many countries continued their quota systems after the war as a means of facilitating the transition from a wartime to a peacetime economy and of safeguarding key industries. In the late nineteen-twenties, international cartels and combines employed both import and export quotas to effect a division of markets, while several European countries adopted tariff quotas for the purpose of protecting a harassed agricultural industry.

France was the first large country to adopt import quotas on a wide scale as a means of combatting the depression. Beginning in May, 1931, the French government issued the first of a long series of

decrees that either limited the quantities of commodities that could be imported into France, or subjected imports to licensing requirements without fixing any limits in advance. By July, 1932, 1133 items of the French tariff code had been placed under quota restriction, comprising about one-seventh of the entire tariff schedule; by 1934, the total number of tariff items subject to quantitative restriction had increased to 3000. France's example was soon followed by several other European countries, and by the end of 1932 eleven countries had full-fledged quota or licensing systems. Although the quota system spread to other areas in the years following, it remained primarily a European instrument of trade control down to the outbreak of war in 1939. Some nations in the Far East, notably Japan, made extensive use of the quota, but in Latin America it won only two converts. The British Dominions and the United States maintained quota restrictions on a small number of commodities.<sup>4</sup>

The countries which had import quotas or licensing systems in force on January 1, 1939, were: Belgium, Bulgaria, Czechoslovakia, Eire, France, Germany, Greece, Hungary, Italy, Latvia, Lithuania, the Netherlands, Poland, Rumania, Spain, Switzerland, Turkey, the United Kingdom (mainly agricultural commodities), and Yugoslavia in Europe; and Afghanistan, the British Colonies, Chile, Iran, Japan, Manchukuo, Netherlands India, New Zealand, and Uruguay outside Europe. These countries had quota or licensing systems applying to a substantial number of commodities. Many other countries had similar restrictions on only a few commodities.<sup>5</sup> Many European countries which relied primarily upon exchange control also adopted quota systems, so that importers in those countries had to obtain from the government not only allotments of foreign exchange, but also import permits, before goods could be brought in.

During the nineteen-thirties, quota systems came to cover an ever-widening range of commodities, affecting in some instances a major portion of a country's imports. Since the usual effect of placing an article under a quota is to raise the price of the article in the importing country, and since there are few imports which do

<sup>4</sup> For a discussion of American import quotas, see C. R. Whittlesey, "Import Quotas in the United States," *Quarterly Journal of Economics*, Vol. LII (1937-1938), pp. 37-65.

<sup>5</sup> Margaret S. Gordon, *Barriers to World Trade*, pp. 248-249. I am indebted to Mrs. Gordon for much of the material in this chapter.

### 434 International Trade and Commercial Policy

not affect, directly or indirectly, the costs of other articles, it is well-nigh impossible to prevent the spread of the quota system, once a country subjects any imports to quotas. As costs rise, more and more interests demand quota protection. The extent of the import trade covered by quotas in the late thirties is revealed by the following figures, which show the percentage of total imports (by value) affected by quota or license restrictions in 1937 in eight European countries that did not employ exchange control:<sup>6</sup>

France	58%	Ireland	17%
Switzerland	52%	Norway	12%
The Netherlands	26%	United Kingdom	8%
Belgium	24%	Sweden	3%

These figures obviously understate by a wide margin the comprehensiveness of quota systems in the countries listed because the very operation of quotas tends to reduce the imports of those goods subject to a quota. In other words, the more restrictive quotas become, the smaller will be the percentage of total imports which those goods subject to quota restrictions constitute. Quotas limited imports of many goods to considerably less than half the quantities entering before the depression. More than one-half of Austrian imports were subject to import license by 1936, and the system of licenses was used extensively by Greece and Czechoslovakia. Germany's and Bulgaria's comprehensive schemes of exchange-permit requirements did not differ at all, in their basic principle, from quota systems.

The selection of the commodities that are to be subjected to import quotas generally reflects the reason for adopting the quota system. The earlier quotas on agricultural products were adopted for the purpose of reducing imports on these products, arresting the decline in domestic agricultural prices, and protecting the living standards of the peasantry. Later, industries which were especially vulnerable to foreign competition, often those producing commodities of which imports had shown a sudden increase, were brought under the protective wing of the quota system. As war became ever more threatening, quota selections came to be dictated more and more by rearmament programs and visions of self-sufficiency. Where the primary objective of quotas has been the improvement of the bal-

<sup>6</sup> League of Nations, *World Economic Survey*, 1938-1939, p. 189.

ance of trade and the preservation of currency stability, luxury goods have been hardest hit. Needless to say, the choice of commodities has also been strongly influenced by the relative strength of various pressure groups.

Some articles have been subjected to quota limitation in order to achieve certain objectives of external policy. Where imports of a specific commodity originate largely in one country, discrimination against that country may be effected, without injury to a third country, by subjecting that particular commodity alone to quota limitation. Italy in 1932 expressed her displeasure with French import quotas by placing under quota restriction imports of wines, liqueurs, perfumes, and soaps; France was the chief supplier of these goods. Lithuania in the same year sought to wring export concessions from countries with whom her trade balance was continuously unfavorable by subjecting to quota limitation selected commodities supplied by those countries.<sup>7</sup> Switzerland, too, used quotas as an instrument of bilateral bargaining. The import quota was too effective a bargaining weapon to be passed up.

The countries which relied most heavily on import quotas during the depression and the early period of recovery were members of the former gold bloc. Belgium, Poland, Switzerland, and the Netherlands, as well as France, were by the end of 1932 relying heavily on import-license systems to improve their trade balances and halt deflation. It is significant that France was able to relax many of her quotas after she devaluated the franc in the fall of 1936.

*Quotas versus Tariffs.* It is not difficult to understand why nations turned despairingly to higher protection as depression swept their economies into a slough of internal deflation and increasing unemployment. One may wonder, however, why, when governments acted to provide more protection to home industry, they did not turn to the established and familiar tool of import duties rather than to the much less familiar import quota. Quotas were employed in this period of stress because tariffs were considered inadequate, or because governments were not always at liberty to use tariffs

<sup>7</sup> These commodities included sugar, salt, artificial fertilizer, and coal; they were supplied chiefly by Italy, Belgium, Czechoslovakia, Holland, Finland, Estonia, and Latvia. Cf. Heinrich Heuser, *Control of International Trade*, Ch. IV.

## 436 International Trade and Commercial Policy

freely. Quotas are more effective instruments of restriction than import duties, for they may be applied, or lowered, merely by administrative decree, and are not subject to the delay and uncertainty of parliamentary debate. They are much more flexible than tariffs; the government is free to act without disclosing its policies and without being forced to defend its policies before legislative bodies.

Quotas also afford a more predictable and a more precise control than duties. A quota can be fixed to admit exactly the amount of a commodity that the government is willing to admit, and no more. While there is a certain duty which at a given time will limit the imports of a commodity to the desired amount, the exact quantity that will enter under any given rate of duty can never be precisely predicted. In a period of falling world prices, furthermore, any given duties provide a constantly diminishing degree of protection, while the effectiveness of quotas is undiminished by price declines.

One obstacle which prevented certain countries from raising tariffs in the early years of the depression was the policy pursued in the late twenties of consolidating duties in commercial agreements. In 1931, for example, consolidation covered 70 per cent of the French tariff schedule, so that higher duties could be applied to only a very limited range of imports. Rates could, of course, be raised against non-treaty countries. But, where a country's general tariff was modified by numerous conventions which were generalized by most-favored-nation treatment, such increases could be applied to only a limited range of a country's imports. Since the treaty obligations could not be denounced without a long period of notice, some other method of restricting imports had to be found.

The quota possesses a definite political advantage over tariff increases. While tariff increases always please the interests favored, provided they are great enough, they also stir up much popular criticism of the government, because it is more or less generally realized that tariff increases cause internal prices to rise. But the belief has been rather widely held that *quotas* have no such effect. It will be demonstrated in the following section that both methods of import restriction tend to result in a rise in the prices of the goods affected.

Since quotas have been found to be more effective tools of restriction than tariffs, they have proved to be more potent bargaining in-

struments. The flexibility of their administration, their exemption from most-favored-nation treatment (they are not exempt in the United States Trade Agreements program), and the precision with which they operate have been persuasive arguments in winning concessions from other countries.

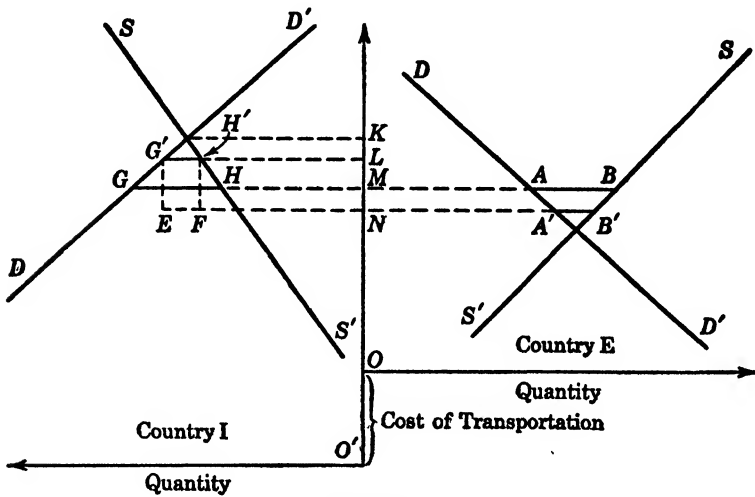


FIGURE 5.

*Effects of Quotas upon Prices.* Since the introduction of a quota system almost inevitably results in restricting imports of those commodities that are made subject to quotas to quantities smaller than would enter under free trade, the application of a quota to any commodity formerly admitted free of duty will cause its price to increase. A price differential between the domestic and the foreign markets that exceeds the costs of transportation between the two markets will appear. The effects of a quota upon prices, production, and consumption may be illustrated by an adaptation of the charts presented in Chapter X.<sup>8</sup> It will be remembered that the traditional

<sup>8</sup> This diagram is based on those used by Professor Haberler in *The Theory of International Trade*, pp. 171-172. The present adaptation is found in H. Heuser, *Control of International Trade*, P. Blakiston's Son & Co., Inc., p. 150; Margaret S. Gordon, *Barriers to World Trade*, The Macmillan Company, p. 233; and K. Häfner, "Zur Theorie der mengenmässigen Einfuhrregulierung," *Weltwirtschaftliches Archiv*, XLI (1935), p. 193.



## 438 International Trade and Commercial Policy

direction of the  $X$  axis has been reversed for Country I, and that allowance is made for the costs of transportation by lowering the whole curve system of Country I relative to that of Country E. Under conditions of free trade, Country I will consume quantity  $MG$ , produce quantity  $MH$ , and import quantity  $GH$ ; the price in Country I will be  $O'M$ . Country E will produce quantity  $MB$ , consume quantity  $MA$ , and export quantity  $AB$ ; the price in Country E will be  $OM$ , which is lower than the price in Country I by the cost of transportation,  $OO'$ . The exports of Country E will equal the imports of Country I, i.e.,  $AB$  will equal  $GH$ , assuming that there are only the two countries.

Now let us assume that Country I applies a quota that limits her imports of the article to  $G'H'$ , which is smaller than the amount formerly imported,  $GH$ . The price in Country I will rise to  $O'L$ , consumption will decline to  $LG'$ , and domestic production will expand to  $LH'$ . In Country E, the price will fall to  $ON$ , production will contract to  $NB'$ , and consumption will increase to  $NA'$ . Country E's shrunken exports will still be equal to Country I's shrunken imports, i.e.,  $A'B'$  will equal  $EF$ . The price differential between Country E and Country I will be further increased, from  $OO'$ —the cost of transportation—to  $OO'$  plus  $LN$ . Consumers in E will be deprived of those low-cost imports represented by  $BB'$ ; this loss in imports will be made up in part by the higher-cost domestic production,  $HH'$ .

It will be noted that the imposition of a tariff equal to  $NL$  by Country I would have produced the same effects on prices, production, and consumption within the two markets and on the trade between the two countries as the enforcement of the quota,  $G'H'$ . But the distribution of the national income would differ somewhat in the two cases. If an import duty of  $NL$  were imposed by Country I, the government would collect duties totaling  $G'EFH'$ . When imports are restricted by a quota ( $G'H'$ ), however, the government receives no customs revenue; the sum represented by  $G'EFH'$  accrues instead to importers as "quota-profits."

The effects of a quota differ from those of a tariff in yet another respect. Although a tariff has the effect of curtailing imports of the taxed commodity, a definite price tie between the two markets is

maintained as long as the tariff is not prohibitive. The price in the importing country will equal the price in the exporting country plus the transportation cost and the duty. If the price in the exporting country falls, the price in the importing will likewise fall. If the demand in the importing country increases, the price in the importing country will rise; but the rise in price will be tempered by an increase in imports and will therefore not be as great as it would be if imports could not be increased. Even if the export price goes up, as it well may, the price differential between the two countries will be maintained—the price in the importing country will remain above the price in the exporting country by an amount equal to transport costs plus the tariff. The quota, in contrast, severs all price ties with outside markets. Its effect is absolute. A fall in the price in outside markets will have no effect whatsoever upon the price or upon the volume of imports in the country imposing the quota, so long as the quota is unchanged. The price differential between the two markets will merely widen. Likewise, a rise in the price in the importing country will not induce a flow of imports to temper the rise; instead, the price differential between the two markets will merely widen—and importers will profit therefrom.

The prices of commodities whose importation is restricted may, however, fail to rise under certain conditions. If the domestic demand declines simultaneously with, or following, the imposition of the quota, the restricted supply may command a price no higher, or even lower, than the former unrestricted supply. During a period of declining incomes, the demands for many goods may decline considerably. Even though demand schedules remain unchanged, the restriction of imports by quotas may not cause prices to rise if importers have anticipated the quotas by increasing their foreign purchases and have refrained from offering their entire supplies for sale before the imposition of the quotas. After the accumulated stocks have been sold, of course, the domestic supply will be reduced to an amount equal to domestic production plus the reduced imports, and the price will rise.

Imports are sometimes subjected to a tariff as well as to a quota. Suppose that in addition to the quota  $G'H'$  a tariff of  $NL$  is imposed upon an article. Quota-profits are now wiped out, and the sum

## 440 International Trade and Commercial Policy

formerly realized as quota-profits,  $G'EFH'$ , goes to the government as customs revenue. A rise in the price of the article in Country I will fail to cause an increase in imports; it will merely widen the price differential between the two markets and create some quota-profits in addition to the customs collections. A decline in the price of the article in Country E will produce similar results. If the price of the article should decline in Country I, less than the quantity  $G'H'$  would be imported, and the quota would cease to be effective. In this case, the price in Country E would also fall, and a new equilibrium would eventuate, with lower prices in each market and a price differential equal to  $NL$ , the amount of the tariff, between the two markets. A price rise in Country E would have similar results, except that prices would be higher in each country.

If the tariff were greater than  $NL$ , the quota would be ineffective. Imports would then be less than  $G'H'$ , and the price differential between the two markets would be equal to the tariff. The quota would become effective only in case the price in Country E fell so low that the imported price in Country I plus the costs of transportation were less than  $O'L$ . If, on the other hand, the tariff were less than  $NL$ , it would be ineffective; imports would be limited by the quota to the quantity  $G'H'$ , and importers would realize some quota-profits. The tariff could become effective only if the price in Country I fell, or the price in Country E rose, to such an extent that the price differential between the two markets equaled the tariff.

Our discussion of the effects of a quota has thus far rested upon the assumption that competition exists in both the exporting and the importing countries. But the very establishment of a quota system favors the formation of monopolies, because the volume of foreign competition then becomes a known quantity and does not fluctuate with domestic price changes. The issuance of licenses to importers facilitates combination; a small group of importers may buy up all the licenses issued. Where importers have succeeded in forming a monopoly, they may find it advantageous to restrict the imports of any particular commodity to a quantity less than the quota. By doing so, they will be able to raise the price above the price that would prevail if the full quota were imported; such a policy will

enable them to enjoy monopoly profits, in addition to their quota-profits.<sup>9</sup>

The restriction of foreign markets by foreign quotas, or by any other means, ordinarily lowers the profits of exporters. Prices in the remaining unrestricted markets of the world may be expected to fall, since a larger supply now has to be disposed of in such markets; and, as long as competition exists among exporters, they can expect to reap none of the quota or monopoly profits in the quota country. Where exporters succeed in attaining monopoly power themselves, however, they may be able to secure all, or a portion of, the quota-profits, and possibly additional monopoly profits as well. But a monopoly among exporters is not easy to establish, since it involves bringing into one combination the exporters in all the exporting countries. Where one nation accounts for practically all the exports of a particular article, however, or where the article is controlled by a few large producers in several nations, monopoly control may not prove impossible of attainment. The achievement of an export monopoly will be made all the easier if the quota-imposing country issues import licenses to exporters rather than to domestic importers. If importers, as well as exporters, possess monopoly power, the division of quota-profits will be indeterminate.

A tariff quota will sometimes operate like a tariff, sometimes like a quota, depending upon whether or not the rate of duty at which goods in excess of the quota are admitted is prohibitive, i.e., greater than the price differential which would exist between the two markets as a result of the quota (*NL* in the diagram). Where the duty on imports in excess of the quota is greater than this price differential, no goods in excess of the quota will enter: the quota will fix the effective limit on imports. Where, on the other hand, the higher duty is less than the price differential, imports in excess of

<sup>9</sup> Heuser points out that such a result is unlikely if the import monopoly happened to be in existence prior to the introduction of the import quota; for then the monopolist importer would have fixed his sales at the point of optimum profitability before the imposition of the quota. Since, in all probability, the quota would restrict imports below their preceding level—the monopolist's optimum point—the monopolist's profits would consequently be reduced. Any further limitation of imports would only reduce his profits still more, since it would move him even farther away from this optimum point. *Op. cit.*, pp. 151-152.

## 442 International Trade and Commercial Policy

the quota will enter. In such a case, the higher duty will set the amount of the price differential between the two markets, and importers will realize a special profit on imports that enter under the quota; this margin of profit will equal the difference between the quota duty and the higher duty. The lower duty on quota imports will not benefit consumers, since all units of the imported commodity will sell for a uniform price.

*Quotas and Domestic Production.* Since one of the avowed purposes of import quotas has been the maintenance and enlargement of domestic production, it is pertinent to examine the effects of quota systems on domestic production.

It was shown in the preceding section that the limitation of the imports of any specific article by a quota will cause the domestic price of the article to rise and its domestic production to increase, provided the domestic demand does not simultaneously decline. There can be no question that in many cases import restrictions did assist in maintaining activity in particular branches of domestic production by reducing some of the over-capacity which had developed when the increased intensity of foreign competition was first felt and, in some instances, by rendering the domestic manufacture of new products profitable. In certain cases, the introduction of quotas caused industries to transfer across national boundaries. The introduction of import quotas by France, to illustrate, was followed by the migration of many Belgian assembly and finishing plants, and even complete factories, to France. To this extent protection achieved its end.

Although import quotas did apparently contribute to maintaining production, and even to increasing it, in *particular industries*, especially agriculture, in those countries that resorted to this form of protection, quotas did not always have such a stimulating effect upon *total* industrial production. The course of industrial production in four European countries that made extensive use of import quotas for the six years, 1930-1935, is presented in the accompanying table. In all four countries, except Greece, industrial production was lower in 1935, after quotas had been in operation for several years, than it was in 1931. It would be foolhardy, of course, to conclude that the decline in the production indices in these quota countries was the result solely of quota systems. Other forces con-

**TABLE 6. Industrial Production in Four Quota Countries, 1931-1935**  
(1925-1929 = 100, yearly averages on the basis of quarterly data)

	1930	1931	1932	1933	1934	1935 <sup>a</sup>
Belgium	95	85	71	75	75	74
France	115	102	79	88	81	76
Holland	105	91	72	79	80	78
Greece	112	116	109	119	136	130

Source: League of Nations, *World Production and Prices, 1934-1935*.

<sup>a</sup> One quarter only.

tributed to this net decline in production, e.g., the world depression and the import restrictions of other nations. There is no way of apportioning to any single factor its proper share of responsibility for the decline.

It is possible, nevertheless, to show that import quotas may react unfavorably upon domestic production. If the domestic production of an article is to rise as a result of the restriction of imports of the article by a quota and the consequent increase in its price, there must be no decline in the domestic demand for the article. Now, as long as the quota system is confined to a very small number of commodities, there is little reason to anticipate that the imposition of quotas will cause a decrease in the demand for any of the restricted goods. But demand cannot be expected to remain stable once the range of the quota system has been widened to include a large proportion of a nation's consumable goods, as was true of many of the quota countries after 1934. On the contrary, demand and supply conditions tend to become much less stable under a regime of import restrictions than under more normal conditions. In the first place, the increased prices of restricted articles tend to cause the demand for other articles to decrease, particularly in a period of shrinking incomes.<sup>10</sup> If a greater share of money incomes is spent on one article, less is available to be spent for other articles. Secondly, production may fail to expand because of a rise in costs; a rise in costs dulls anticipations of profits. Many of the restricted imports will be goods whose prices enter, directly or indirectly, into the costs of other goods, e.g., raw materials, semi-manufactured

<sup>10</sup> If the demand for the restricted articles is elastic, an increase in the prices of these articles may cause the demand for other articles to increase. Most quota systems, however, embraced many articles for which the demand was inelastic.

## 444 International Trade and Commercial Policy

materials, and foodstuffs. Sometimes the creation of new industries or the expansion of existing industries calls for the services of certain scarce factors of production; these factors can be hired away from other employments only by bidding up their prices. Finally, the export demand for many goods is almost certain to decline if imports are restricted. Foreign countries, unable to sell their entire production of the restricted goods, or compelled to sell more of these goods outside the quota country at reduced prices, will have less foreign exchange with which to purchase the latter's goods. The higher costs in the quota country, too, will weaken its competitive power in world markets. Furthermore, quotas, even more than tariffs, provoke retaliation. Within a few months after the adoption of the quota system by France, nineteen other countries had followed the French example, and by August, 1934, the number of imitators had increased to twenty-seven.

The tendency for exports to decline *pari passu* with the restriction of imports explains why the adoption of quotas for the purpose of improving the balance of trade may prove disappointing. But the introduction of a quota system may not only fail to bring any pronounced betterment in the balance of trade. It may also cause certain credit items in the balance of payments to decline, and thus fail to relieve the pressure against a country's currency. If the nation has a large merchant marine, the shrinkage in international trade caused by the quota system will reduce the earnings of its carriers. If it is a haven for tourists, the rise in internal prices, i.e., relative to other countries, will tend to discourage much of its tourist business. And, if it is an important creditor nation, its international receipts on interest and dividend account will diminish, as quotas restrict the exports of debtor countries, and hence their ability to meet international obligations.

The decline in these credit items in the balance of payments will have further unfavorable repercussions upon domestic production. Dr. Heuser points out that the decline in the tourist trade in Switzerland hit certain domestic industries catering to that trade particularly hard; the building industry was one of these.<sup>11</sup> Reduced receipts of interest and dividends will mean a diminished demand for various goods, especially luxury goods. Unemployment in the

<sup>11</sup> *Op. cit.*, p. 196.

shipping industry will cause the demand for various other goods to decline.

*Allocation of Quotas.* The fixing of appropriate import quotas for a large number of commodities is too gigantic and cumbersome a task to be undertaken by parliament. The authority to fix quotas or to grant licenses for imports is therefore ordinarily granted to the executive branch of the government by statute. The responsibility for fixing quotas may be given to a special control board or to some of the existing governmental agencies. Thus, in France, the Ministry of Shipping determines the quotas for fish, the Ministry of Agriculture sets the quotas for agricultural and animal imports, and the Ministry of Commerce and Industry fixes the quotas for manufactured goods. The choice of the commodities that are to be placed under a quota is usually left entirely to the administrative bodies, but the objectives of the system are set forth in the law. This control by administrative bodies makes possible the frequent alteration of quotas to cope with changing economic conditions; parliaments obviously cannot give a quota system continuous supervision.

The length of the quota period varies from country to country; it also varies according to the nature of the commodity and the purpose of the quota. The longest period is a year and the shortest is a month, with a three-month interval probably the most common. Annual quotas may be broken down into sub-quotas, which, in turn, may be distributed unevenly over the year in order to make allowance for seasonal variations in supply or demand. Quotas are usually fixed as some percentage—almost always less than 100 per cent—of the nation's imports in an earlier base period. When shipments in excess of the quota occur, and such excess shipments cannot always be avoided, the amount of imports in excess of the quota is charged to the succeeding quota period.

The allocation involves two distinct problems: the apportionment of imports among the domestic importers, and their apportionment among the various supplying countries. The earliest quotas, known as "global" quotas, attempted no solution of either problem. A fixed world quota that took no account of the country of origin was announced, and imports were permitted to enter the country until this quantity was exhausted. No specific restrictions were imposed upon individual importers or upon foreign exporters; all were left



## 446 International Trade and Commercial Policy

free to conduct their business, within the limits of the quotas, without molestation by the government.

Certain weaknesses of the global quota, however, soon became manifest. It caused a flood of imports from all directions, as each shipper strove to move his goods across the frontier before the quota should become filled. Sharp price fluctuations inevitably followed; unusually large supplies appeared on the domestic market early in the quota period, only to be followed by shortages toward the end of the period. Individual importers suffered, also; those whose goods arrived after the quota had been filled were put to the expense and inconvenience of reexporting their goods to some other country or storing them until the beginning of the next quota period. A more important weakness of the global quota was the discrimination among exporting countries which it introduced. Neighboring countries were naturally able to get the lion's share of the quotas, to the detriment of more distant countries.

One way of avoiding the discrimination among exporting countries which the global quota inevitably entails was found in the adoption of country quotas. The country quota allocates a specific proportion of the total quota to individual countries on some predetermined basis. Ordinarily, a base period is chosen in which the volume of trade is considered to have been "normal," a certain percentage of "normal" imports is taken as the total quota, and the total quota is then divided among individual countries in proportion to their trade during the base period. Country quotas proved to be superior to the global quota in that they safeguarded the interests of exporting nations and at least appeared to uphold their rights as expressed in the most-favored-nation clause. It was still possible to discriminate between exporting nations under the country quota, however, by arbitrarily selecting the base period. A nation like Japan, for example, whose exports exhibited a spectacular increase from 1932 on, could be discriminated against by choosing as a base for the allocation of import quotas a period when her exports were relatively small, such as 1929-1931.

The allocation of the total quota among exporting countries, however, does not end the administrative difficulties that are engendered by the introduction of a quota system. Although the regulations require the closing of the frontier as soon as the full quota has been

admitted, it is not possible, when imports are entering through many customs houses at scattered points, to collect the statistics of imports and proclaim that the quota has been filled before it has been exceeded. In order to overcome this difficulty and make restrictions really effective, some control over the volume of trade at the source has to be exercised. A second difficulty with the country quota is that it imposes an undesirable rigidity with respect to the sources of supply. This type of quota makes no allowance for changes in costs or in the other conditions of supply, although the relative importance of various countries as sources of the supply of any given commodity may change markedly in either the short run or the long run. When price increases render purchases in certain quota countries unprofitable, consequently, quotas for those countries are not utilized, and total imports fall below the volume permitted. Still another difficulty with the country quota is its tendency to encourage speculation. The existence of a differential between the domestic and the foreign price, which gives rise to quota-profits, tends to attract professional speculators and to work to the disadvantage of importers regularly engaged in the trade.<sup>12</sup>

Other ways of allocating quotas to exporting countries in order to make quotas completely compatible with the most-favored-nation clause have been suggested. One is to issue licenses to importers but at the same time to leave them free to choose the sources of their imports in accordance with commercial considerations. The main objection to this method is that the authorities in the importing country can easily exert pressure on importers to make their purchases in specified countries. Such pressure might be applied by threatening to withhold licenses from recalcitrant importers in the next quota period. Another method that has been suggested is to allot equal quotas to every country entitled to most-favored-nation treatment. This method would obviously work to the disadvantage of countries which would normally be the chief suppliers; and, since most imports are supplied by a relatively few countries, it would restrict actual imports to an amount less than the total permitted.

Some countries have apportioned only a fraction of the total quotas to exporting countries in proportion to their relative shares

<sup>12</sup> This can also happen under the global quota.

## 448 International Trade and Commercial Policy

of the imports in the base period, and have reserved the balance of the quotas for bargaining purposes. In 1933, France allotted only 25 per cent of her quotas to foreign countries on the basis of their previous trade, and reserved the remaining 75 per cent for apportionment among the supplying nations according to their willingness to grant concessions to French exports. The Netherlands has employed similar tactics. Hungary, Poland, and Czechoslovakia have never revealed the bases upon which their quotas were allocated among exporting nations. Some of the factors which they appear to have taken into account are "commitments made in published or secret bilateral commercial agreements, the state of the balance of trade with individual countries, political considerations, the existence or nonexistence of a clearing or payments agreement and the nature of the provisions of such agreements, the state of clearing balances, and the provisions of international cartel agreements."<sup>18</sup>

The shortcomings of country quotas have led to the introduction of a third variant of the quota: the requirement that importers of products subject to quotas secure import licenses for each specific importation. By this means, complete and centralized control over both the volume of imports and the identity of the importer is possible. Licenses are distributed within the framework of either a fixed global quota or specific country allotments. Despite the advantages of this form of the quota over the global and country quotas, its supervision places a heavy burden upon the administrative authorities. The receipt and consideration of license applications involves considerable red tape, and elaborate records of imports in earlier periods have to be kept.

There are various methods by which quotas may be allotted to importers. The method most widely used is to distribute import permits for any particular article among importers in proportion to the volume of business conducted by each in some preceding period. The difficulty with this method of apportionment is that only those individuals or firms who were in business during the base period can obtain licenses; newcomers are automatically excluded. The Swiss government, after several years of experience, sought to remedy this situation by reserving a certain percentage of its total

<sup>18</sup> From Margaret S. Gordon, *Barriers to World Trade*, p. 276. By permission of The Macmillan Company, publishers.

quotas for allotment to new firms, or to existing firms which could claim special treatment. But, in any case, large firms are able to maintain their dominant position through their ability to secure the bulk of the quota. Where the importers are members of a cartel or trade association, entire quotas have in some instances been turned over to the cartel or trade association for distribution among importers. Professor Haberler has recommended the sale of import licenses to the highest bidder, as the simplest and most equitable means of distributing quotas among importers. By this device, all importers, long-established firms and newcomers alike, are given an equal opportunity to acquire licenses. This scheme has the added merit that it yields to the government revenue approximately equal to the quota-profits which would otherwise go to the importers, since competitive bidding would force the price of licenses up to roughly the equivalent of the quota-profits anticipated. Although no country has employed this method of allocating quotas, France after 1933 sold licenses at a fixed fee; this had the effect of taxing away sizable shares of prospective quota-profits. If the license fee is set higher than the quota-profits, it will obviously restrict imports to an amount less than the quota.

A fourth method of controlling the volume of imports is to require that an export certificate accompany every shipment of goods on its arrival at the customs house and to arrange for the issuance of these certificates by the government of the exporting country or by an association of exporters. This is known as the "bilateral" quota, or *contingent amiable*, and has been employed on a wide scale by France. The size of the quota is usually determined by negotiation between dealers or producers in the two countries; the quota is then announced by the government and is given the force of law.

The bilateral quota enables the government in the importing country to avoid the troublesome problems of fixing quotas and issuing licenses. Another consideration which induced the French government to adopt bilateral quotas was the belief that such quotas would facilitate the formation of international cartels, which, it was hoped, would inject an element of stability into world markets. Although bilateral quotas held out to exporters prospects of quota-profits, and even of additional monopoly profits, these so-called "friendly" quotas were not always voluntarily accepted by the for-

## 450 International Trade and Commercial Policy

eign interests concerned. They were frequently forced upon exporters, under the threat of the imposition of a more rigorous unilateral quota in the event of non-compliance. The bilateral quota has not been over-popular with consumers or with importers in the importing countries. The former have felt that it subjects them to exploitation by foreigners; the latter have resented the loss of quota-profits. France had largely discontinued the bilateral quota by the end of 1933.

### MILLING, LINKED-UTILIZATION, AND LINKED-PURCHASING REGULATIONS

Various other measures that have been designed to promote the consumption of domestic products at the expense of foreign products are worthy of mention. These include such devices as milling, linked-utilization, and linked-purchasing regulations and import monopolies.

Linked-utilization measures forbid the use of a designated foreign product unless a similar, or closely allied, domestic product is utilized with the foreign product in some specified proportion. Linked utilization may cause no serious processing difficulties if the commodities are reasonably satisfactory substitutes for each other. The most common of these linked-utilization measures are milling regulations, which require the admixture of a specified minimum of domestic grain with all imported grain utilized by millers in their milling operations. Needless to say, the minimum percentage of domestic grain specified is always greater than the percentage that millers would use in the absence of government regulation. Analogous to milling regulations are regulations, commonly found in petroleum-importing countries, that require the admixture of alcohol with gasoline (a concession to the farmers who raise the crops from which the alcohol is derived), the blending of butter with margarine, the mixture of wool or silk with staple, i.e., artificial, fiber, and national film quotas. The last type of regulation is illustrated by the Italian government's decree of June 13, 1935, which required all Italian theaters to show one domestic film for every three foreign films shown.

Actual linked *utilization* may not be required. The same ends may be attained by requiring merely the linked *purchasing* of foreign

and domestic materials. The New Zealand Government, for example, required purchasers of woolpacks to buy a given proportion of packs made of native flax as a condition of receiving permits to import packs of Indian jute. Late in 1931, permission to import foreign sugar into Latvia was made contingent upon the purchase of Latvian-refined sugar from the government-owned sugar mill in the proportion of ten tons of domestic sugar for every ton of foreign sugar imported. Permits to import Polish poultry and eggs into Switzerland were made conditional upon the purchase of stated proportions of the local product. Linked-purchasing regulations are simpler and probably easier to enforce than those calling for the linked utilization of foreign and domestic products.

The decline of agricultural prices after 1929 caused a rapid spread of milling regulations for wheat. Germany and France adopted such measures in 1929, Sweden in 1930, and Latvia, Czechoslovakia, Greece, and Peru in 1931. By the end of 1931 most of the wheat-importing countries of Continental Europe had milling regulations in force; during the years following many non-European countries joined the ranks, including Brazil, Mexico, and the Irish Free State. In her struggle for self-sufficiency after 1933, Germany made extensive use of linked-utilization and linked-purchasing measures; Japan, too, employed such measures on a wide scale, particularly after the occurrence of the "China Incident." Outside of Germany and Japan, however, linked-utilization and linked-purchasing regulations have played an insignificant role, compared with other forms of import restriction.

It may be wondered why linked-utilization measures, which are obviously more complex and more difficult to enforce than simple import quotas, should have been adopted. Why not adopt the more simple, and fully as effective, import quota? One reason for the choice of linked-utilization measures was that, being a means of *indirect* import restriction, they did not formally conflict with commercial treaty obligations. Moreover, since milling regulations had been an accepted practice in many Continental countries even before the first World War, their extension involved a less radical departure from established practice than the introduction of the less familiar import quota. Lastly, it was believed in many quarters that linked-utilization measures would impose a less heavy burden

## 452 International Trade and Commercial Policy

upon the consumer than the quota, where the same level of protection was sought.

The relative effects of quotas and linked-utilization measures depend upon their respective severity. A quota on wheat of zero, i.e., the complete prohibition of wheat imports, would force the domestic price of wheat to rise no higher than would regulations requiring millers to produce all flour entirely of domestic wheat. This is, of course, an extreme case. Usually some imports are permitted under either type of control. Where an import quota is employed, the imported wheat will, as has been demonstrated, bring the same price as domestic wheat, of the same grade, and the price of domestically-ground flour will be governed accordingly. Where milling regulations are employed, on the other hand, the price of domestic wheat will probably be forced up, since the proportion of domestic wheat will be set higher than that ordinarily used; but the domestic price of imported wheat will not be raised, as it is under the quota. How high the price of flour will be pushed depends upon the proportion of domestic wheat required: the higher the required proportion of domestic wheat, the higher will its price rise, and the higher will be the price of flour.

Both quotas and linked-utilization requirements are subject to frequent variation. Short domestic crops are likely to bring an enlargement of the import quota or a reduction in the proportion of the domestic product required, while bumper domestic harvests will bring a reduction in the quota and an increase in the proportion of the home product that must be used. But, in the longer run, the almost inevitable result of both quotas and linked-utilization measures is to stimulate domestic production and to diminish a nation's dependence upon imports. Once higher-cost producers are lured into production, a new vested interest is created, and the pressure to reduce quotas or to increase the proportions of the domestic products required becomes irresistible.

### IMPORT MONOPOLIES

The exclusive right to import a specific commodity, or a group of commodities, is sometimes granted the government or some agency designated by the government. These import monopolies may have various objectives. The tobacco and salt monopolies which have

existed for years in certain countries were established primarily for the purpose of securing revenue for the government. Import monopolies have been set up on occasion in order to secure the economies of large-scale purchasing, especially in the purchase of commodities obtained largely from abroad, although it may be questioned how substantial the purchasing economies actually realized by import monopolies have been. In more recent years, import monopolies have been created for the purpose of protecting domestic producers, without at the same time subjecting the domestic consumer to as heavy a burden as certain other types of import control would impose upon him. In order to provide this protection and lighten the burden on the consumer, the import monopoly usually buys the entire domestic output at a price well in excess of the world price, and imports a certain quantity at the world price. The total supply is then sold in the home market at a price somewhere between these two prices. The domestic producer thus receives a subsidy, but the price the consumer pays is less than the world price plus the subsidy. Other things being equal, the larger the proportion of imports, the lower will be the price to the consumer. When the import monopoly conducts such operations, it is not seeking to maximize its profits.

The import monopoly has certain other advantages over the quota. It avoids the difficult problems connected with the distribution of licenses to importers. It is not compelled to buy from countries in proportion to their sales in some earlier period; it may purchase strictly on a price and quality basis, or it may distribute its purchases with their political and bargaining influence in mind. It can prevent quota-profits from accruing to importers, either by lowering the prices of its goods to consumers or by turning its profits over to the public treasury.

Some so-called import monopolies that have been created in recent years have not operated as importing concerns but have exercised their monopoly powers for the sole purpose of issuing licenses to importers. Such monopolies determine the amount to be imported with reference to some definite policy, such as maintaining a relatively stable price on the home market, and issue importers' licenses accordingly.

Import monopolies of wheat and flour have been granted in many



## 454 International Trade and Commercial Policy

countries on the continent of Europe in the last decade or two, and in many instances such monopolies have been extended to other cereals. Norway, Switzerland, Estonia, Sweden, Latvia, and Czechoslovakia all had grain monopolies at one time or another, while France, Italy, and Portugal had monopolies of wheat. Germany and the Netherlands before the recent war controlled all agricultural imports of importance through import monopolies. Import monopolies have also been established for various non-agricultural commodities, including coal, coke, tin, copper, and nickel by Italy, and gasoline, petroleum, and petroleum products by various Latin American countries. Only Soviet Russia has established a relatively complete state monopoly of foreign trade, although Iran made all foreign trade subject to a state monopoly in 1931, while permitting private firms to conduct actual trade subject to import permits. By and large, however, the proportion of world trade carried on by government monopolies has been relatively insignificant.<sup>14</sup>

In summary, import monopolies may achieve a given degree of protection at a lower cost to consumers than would be involved by imposing a quota designed to yield the same degree of protection, or they may operate to exploit the consumer. They may permit trade to follow the course of comparative advantage by purchasing strictly on a price and quality basis, or they may discriminate among exporting nations for ulterior ends. They may amount to little more than a system of import licenses under which quota-profits are taxed away by license fees, as was the case in the Netherlands; or they may, while appearing to be merely a system for issuing licenses to importers, go far in the direction of state control of foreign trade, actually allowing importers little initiative, as was the case in Nazi Germany.<sup>15</sup>

### CONCLUSION

The very effectiveness of import quotas and import monopolies is the strongest argument against them. Their popularity in the decade of the 1930's rested upon their ability to fix the volume of imports with precision and to destroy the price link between the domestic

<sup>14</sup> Russia's share in world trade just before the outbreak of war in 1939 was only 1.3 per cent of the total.

<sup>15</sup> For a more complete discussion of import monopolies the reader is referred to Gordon, *op. cit.*, pp. 301-314.

and the foreign market. Import quotas, like protective tariffs, tend to spread rapidly, once they have been introduced. The increases in the prices of the protected products which they entail constitute increases in costs to other industries, which in turn demand quota protection for their products. Even industries whose costs may be little affected by other quotas will demand their share of the benefits from the quota policy.

It was to be hoped that, since quotas were introduced as purely emergency measures, they would be abolished as soon as the emergency had passed. This hope has failed to materialize. Economic recovery after 1934 brought some liberalization of quotas, either autonomously or under the terms of bilateral commercial agreements; but no country, except Switzerland, had made any substantial modification of its import restrictions before the war. France, after the devaluation of 1936 had relieved the pressure on her currency and halted internal deflation, removed the quotas on a few of her imports; but her quota system remained largely unchanged.

The retention of comprehensive quota systems in the postwar era will hinge upon the nature of the world economy. If this economy is based upon nationalistic economic planning, every national economy will have to be insulated from every other national economy. In such a case, it is to be expected that import quotas, import monopolies, and all other forms of trade restriction will be indispensable to the planners. If, on the other hand, the world can establish a liberal trading system, or if some form of international planning can be attained, there will be little room for trade restrictions, including import quotas and import monopolies. But either one of the last two courses presupposes a drastic reversal of the economic philosophy of the two decades following World War I.

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## *Exchange Control*

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### THE NATURE OF EXCHANGE CONTROL

Exchange control, in the widest sense of the term, may be said to include any measures taken by the government to influence foreign exchange rates. In this broad sense, even the adoption of the gold standard would have to be considered a form of exchange control, for adherence to the gold standard sets definite limits to the fluctuations in the exchange rates of all gold-standard currencies. Actions taken by the central bank to control the money market would also have to be included, since such actions, e.g., altering the rediscount rate and open-market purchases and sales of bills and "governments," affect the demand for and the supply of foreign exchange, and hence exchange rates. A more positive form of exchange control is the active intervention by the government in the foreign exchange market for the purpose of influencing directly the demand for and supply of foreign exchange. This form of control is illustrated by the "pegging" of the dollar-sterling rate by the British government during the first World War: British government agents supported the pound by purchasing all sterling offered at a fixed dollar price. More recently, both the British Exchange Equalisation Account and the American Stabilization Fund have put at the disposal of their respective governments huge resources for the purpose of controlling foreign exchange rates.

As more commonly understood, however, the term "exchange control" is not applied to any of these measures. It is used rather in a much narrower sense to refer to various systems of exchange *restrictions*. These measures seek to maintain the price of foreign exchange at a given level by reducing the demand for, or, to a lesser degree,

## 458 International Trade and Commercial Policy

by increasing the supply of, exchange, through restricting the range of activity of individuals engaged in purchasing or selling exchange. The rigor and scope of these restrictions have varied considerably from government to government, and from time to time with the same government. It is in this last sense that the term "exchange control" will be employed in the present context.

Exchange control, in even the broadest meaning of the term, tends to create an artificial value for foreign exchange; that is, the rate tends to differ from the rate that would prevail if the currency consisted of inconvertible paper and if there were no restrictions upon transactions in foreign exchange. Since exchange restrictions are in most cases introduced only in emergencies—war, political disturbance, economic upheaval, or financial crisis—when the external value of the currency is under pressure and the gold standard is threatened, the object of exchange control is usually to prevent the external value of the currency from depreciating—or, what is the same thing, the price of foreign exchange from rising. In order to accomplish this, the demand for foreign exchange must be restricted, and the supply must be prevented from declining, if possible.

A thoroughgoing system of exchange control will have to bring under control all transactions that affect the demand for and the supply of exchange: merchandise imports and exports, international services of all types, international movements of capital, and speculative transactions. This comprehensive control is usually achieved by establishing a monopoly of foreign exchange under some government agency, frequently the central bank. All foreign exchange acquired from export transactions must be sold to this agency at the official rate. The agency then has the responsibility of allocating the limited quantity of exchange among the various demands. The propensity of governments that have adopted systems of exchange control to set an official exchange rate that invariably overvalues the domestic currency has led in most countries to the development of a "black market," in which illicit dealings in foreign exchange are carried on beyond the control of the official agency. These "black markets" have offered a serious challenge to the success of exchange-control systems, with the result that illegal dealings in foreign exchange have inevitably been made subject to severe penalties.

Exchange control is a much broader form of foreign trade control than import quotas. Quotas deal exclusively with commodity trade. Exchange control, on the other hand, deals with all forms of international economic transactions—services and capital movements as well as commodity trade. This difference in the scope of the two systems of control explains in large part why quotas were introduced in some countries, and why exchange control was adopted in others. Where the objective of foreign trade control was the maintenance of domestic economic activity or the improvement of the balance of trade, import quotas were chosen; where the objective was the correction of an adverse balance of payments, the stoppage of the withdrawal of foreign credits, or the termination of an external drain on a nation's gold reserves, the form of control selected was exchange control.

#### WHY EXCHANGE CONTROL WAS INTRODUCED

During the first World War, the belligerent nations made widespread use of exchange control in order to conserve their limited supplies of foreign exchange, to give the government more effective control over scarce cargo space, and to bring under more effective control the external value of their currencies. Most of these war-time control systems were abandoned in the period of prosperity, 1925–1929. The monetary panic and liquidity crisis of 1931, however, caused a reappearance of exchange-control systems on a scale even more extensive than that of the war years.

This reemergence of exchange control, beginning in 1931, was intimately associated with three economic developments of international importance: (1) the decrease, and virtual cessation, of capital imports into the countries of central and southeastern Europe and Latin America in 1929 and 1930, (2) the relatively greater decline in the prices of export goods than in the prices of import goods in those countries whose exports consisted chiefly of agricultural products, and (3) the financial difficulties of the *Creditanstalt* in Vienna in 1931. The decline in the flow of capital to central and southeastern Europe and Latin America was caused by the increasing speculative interest in the American security markets in 1928 and 1929, which diverted capital to New York, and by the stock market crash and the decline in commodity values that followed,

## 460 International Trade and Commercial Policy

which produced a strong preference for liquidity. Countries whose balances of payments had become adjusted to a constant inflow of capital suffered severe external drains of gold when this capital inflow declined, or completely ceased. Before equilibrium could be restored to their balance of payments, their gold reserves had usually become exhausted and the external values of their currencies had undergone severe depreciation.

The restoration of equilibrium to a country's balance of payments is made extremely difficult when, in addition to the stoppage of capital imports, the world prices of one's exports are declining, as was the case with many debtor countries whose exports consisted primarily of agricultural products. The failure of the Austrian *Creditanstalt* in the spring of 1931 injected into this situation of international instability an even more disturbing note, that of panic. Large-scale and persistent withdrawals of short-term credits set in, first from Austria, then from Germany, and finally from Great Britain and other countries. The United States did not escape the panic, and suffered heavy losses of gold in the fall of 1932. The external drain of gold was often accompanied by an internal drain, as the public lost confidence in its banking structure, or became fearful of currency depreciation, and hurried to convert its bank balances and bank notes into gold or commodities.

Exchange control was not the only means available for stemming the outflow of liquid capital, relieving the pressure on the foreign exchanges, and conserving monetary reserves. Three other policies also offered some promise of solving these difficulties, viz., deflation, moratoria, and exchange depreciation. Why was exchange control adopted in preference to one of these policies?

The orthodox adjustment would have been deflation. Deflation would have avoided the disruption of the international monetary mechanism (with its fixed gold parities), defaults on international loans, and totalitarian interference with exchange dealings and foreign commerce. Central bank action might have been expected to lower domestic prices and costs relative to world prices, and a sufficient reduction in domestic costs might have been expected to produce a merchandise export surplus of sufficient size to balance the outflow of capital, and even to reduce it. But there is little reason to believe that attempts at deflation in 1931 could have succeeded

in curbing the outflow of capital. Even a drastic rise in the rediscount rate of the central bank may be quite ineffective in allaying the fear which underlies a flight of capital, if this fear is of sufficient intensity. Furthermore, strong labor unions, the cartelization of industry, and irreducible "social budgets" had introduced into national price structures a high degree of inflexibility that would have endangered the success of any attempt at deflation. Finally, any consideration of deflation would have had to take into account the social costs of unemployment, and the political consequences thereof.

Moratoria offered no more promise of solving the balance-of-payments difficulties created by the withdrawals of foreign capital than did deflation. If moratoria are not to signify outright repudiation, they eventually necessitate negotiation and agreement with foreign creditors. But it was the opinion of finance ministers that fruitful results from negotiations with foreign creditors could not be expected until the effort of transfer had completely broken down. Another shortcoming of moratoria is that they fail to cover the flight of domestic capital, and the expatriation of domestic capital was every bit as troublesome as the withdrawal of foreign capital.

The third alternative to exchange control, viz., exchange depreciation, was seriously considered by many nations, and was actually adopted by some, including Great Britain and the United States. Exchange depreciation involves either an act of devaluation, or the abandonment of the gold standard, while the rate of exchange is left to sink to its "natural" level. For the countries that adopted exchange control, however, two considerations counted against depreciation. Debtor countries realized that a reduction in the external value of their currencies would cause the burden of their foreign debts to increase. In the case of Germany, there was the added consideration that any advantage which German exports might secure from currency depreciation would be offset, in part at least, by the higher prices which would have to be paid for imported raw materials, and a large proportion of the raw materials which enter into German exports have to be imported. But the really decisive consideration against currency depreciation was the fear that the man in the street would associate in his mind the depreciation of the external value of the currency with inflation, and that this would



## 462 International Trade and Commercial Policy

cause a scramble for goods and equities and would actually produce inflation. No country in Central Europe could face this risk after the disastrous experiences of the postwar years.

It must not be thought, however, that the adoption of exchange control means the exclusion of other methods of adjusting balance-of-payments disequilibria. It was pointed out in the preceding chapter that many countries that resorted to exchange control also made use of import quotas. Germany, the country in which exchange control found its most elaborate development, made wide use of standstill agreements and transfer moratoria, and, under the Brüning government, undertook the deflation of internal costs and prices. Austria employed exchange control for the purpose of temporarily insulating her economy from the decline in world prices; at the same time, she prosecuted a policy of currency devaluation, so cautiously and piecemeal that she succeeded in avoiding a rise in internal prices. When devaluation was completed in 1934, she was able to dispense with exchange control, except in unavoidable clearings and in the embargo of capital exports. Many Latin American countries which had been forced off the gold standard, and whose supplies of gold and foreign exchange were inadequate to set up stabilization funds or to link their currencies to sterling, instituted exchange control in order to limit fluctuations in their foreign exchanges and keep the burden of their foreign debts within reasonable bounds.

While systems of exchange control were originally introduced in order to prevent the flight of capital, conserve the gold reserves, stabilize the exchange rates, and provide temporary insulation from external deflation while international adjustments were being worked out, they were later employed for other purposes. Governments found that foreign exchange control could be employed to secure cheap foreign exchange for servicing their external debts. Industry quickly discovered that it was a most effective instrument for the protection of home industry and a powerful tool for retaliating against the exchange controls, tariffs, quotas, and other trade restrictions of foreign countries. After the rise to power of the National Socialists, exchange control was used in Germany for the furtherance of economic and political power both at home and abroad. Imports which the totalitarian authorities deemed essential

were admitted, while those deemed non-essential were excluded, to the profit of certain domestic interests and foreign countries, and the confusion of others. Exchange control is a most effective device for regulating international economic relationships because it controls *all* the items in the balance of payments.<sup>1</sup>

### THE TECHNIQUE OF EXCHANGE CONTROL

The scope and severity of exchange control systems vary widely. Some place such modest restrictions upon the play of free market forces that the weight of the official hand is scarcely felt by commerce and industry. Others are so comprehensive that they bring virtually all phases of economic activity directly or indirectly under official control.

The sources of the demand for and the supply of foreign exchange with which all systems of control are concerned, wholly or in part, may be conveniently classified into three groups: (1) speculative transactions, (2) capital and capital-service items, and (3) imports and exports of goods. Some systems of control have also been concerned with travel and other services. Some mild systems of control seek merely to prevent sharp fluctuations in exchange rates by preventing speculative transactions. Genuine economic capital movements are permitted, and no attempt is made to maintain the foreign exchange rate at an artificial level. Speculative dealings may be sufficiently curbed by impressing upon foreign exchange dealers that such dealings are disapproved by the govern-

<sup>1</sup> Exchange control was in force in the following countries prior to the outbreak of war in 1939 (the dates refer to the year exchange control was introduced):

Before 1931	Bulgaria, Portugal, Turkey
1931	Brazil, Spain, Germany, Hungary, Chile, Uruguay, Colombia, Greece, Czechoslovakia, Bolivia, Yugoslavia, Latvia, Austria, Argentina, Nicaragua, Denmark, Estonia
1932	Costa Rica, Rumania, Japan, Paraguay
1933	Mexico
1934	Honduras, Italy, Cuba
1935	Danzig, Lithuania, Hong Kong
1936	Iran, Poland, Venezuela
1938	China, Afghanistan, New Zealand

Exchange control was also imposed temporarily in various other countries. List reprinted from *The Reconstruction of World Trade* by J. B. Condliffe, p. 232 n., by permission of the publishers, W. W. Norton & Company, Inc., New York. Copyright, 1940, by the publishers.

## 464 International Trade and Commercial Policy

ment; if the profits from speculation are large, however, it may be necessary to limit the exchange made available to speculators by concentrating all exchange dealings in the hands of an official agency. But, in most cases, it is necessary to go beyond the mere suppression of speculative exchange transactions and to control the outward flow of capital if currency depreciation is to be prevented. This necessitates a state monopoly of the trade in foreign exchange. All outward movements of capital are prohibited, except those that receive official approval. The prohibition of capital exports implies a far-reaching interference with exchange dealings by the government, even though no enforcement of an official rate of exchange and no rationing of exchange are involved.

Mild systems of exchange restrictions, designed to prevent extreme fluctuations in the exchanges by discouraging speculation and forestalling flights of capital, have nearly always been introduced immediately preceding or directly following the suspension of the gold standard. They have been adopted most commonly by creditor countries in a relatively strong financial condition as a means of helping them over the transition period of currency depreciation or devaluation. They have not been maintained for long. The most characteristic feature of these mild systems has been a general supervision of all applications for the purchase of foreign exchange, supplemented by prohibitions on the export of bank notes and securities, as a further check on capital outflow, and by specific measures against dealings in forward exchange, as a curb on speculation.

More thoroughgoing systems of exchange restrictions have been compelled to evolve elaborate controls over both the supply of and the demand for foreign exchange. Usually, it is required that all foreign balances accruing from exports be turned over to the exchange authority.<sup>2</sup> It was quickly discovered, however, that, if exchange control was to be made effective, means for preventing the evasion of these surrender provisions had to be devised; for, despite a substantial export surplus, the foreign exchange holdings of the central banks of several exchange-control countries were found to be diminishing. Many exporters were selling the receipts from their

<sup>2</sup> Some countries have exempted drafts for amounts below a certain minimum from the surrender provisions, although in most cases the minimum has later been reduced or removed entirely.

sales abroad in the "black" market, because the rate obtainable there was much above the official rate. Others were selling abroad on long-term credits, so that current exchange from their exports was not being made available to the official agency. Still others were depositing abroad the proceeds from their exports, or were repaying their foreign debts with the receipts from their foreign sales. In some cases, exporters were unable to collect payment from their foreign debtors because of the exchange restrictions of foreign countries; the proceeds from current sales of merchandise consequently accumulated abroad as frozen commercial credits.

Governments sought to prevent such evasions by requiring that exporters make a declaration containing full details concerning the value of every shipment. Under-valuation, which would make it possible for exporters to leave a part of their receipts abroad, was to be prevented by carefully checking the prices in the invoices. Exporters were forbidden to extend credit to foreigners without the express permission of the authorities. Exporters' invoices had to be expressed in terms of the foreign currency; this made it impossible for foreign importers to purchase the currency of the exchange-control country, usually obtainable abroad at a substantial discount, or to utilize balances in the control country, for the payment for their imports. Heavy penalties were provided for illicit dealings.

If the official rate was to be made effective for all foreign exchange dealings, it was essential that foreign balances acquired from all other current transactions also be turned over to the exchange agency. Many countries required shipping companies and insurance companies to render an accounting of all their foreign dealings. But the foreign transactions of private individuals were more difficult to check on. All holders of foreign currencies or claims in foreign currencies were required to register their holdings and to offer them for sale to the central bank, or other exchange agency. From these latter sources, central banks were wont to replenish their reserves of exchange when they dropped dangerously low.

The registration with the government, or central bank, of all holdings of foreign securities, too, has been not uncommon. Such registration serves the double purpose of better checking the receipts of interest and dividends from foreign sources and of giving the government detailed information of large foreign assets which

## 466 International Trade and Commercial Policy

can be readily liquidated if the need for foreign funds becomes sufficiently urgent. If the need arises, the owners of these securities can be compelled to sell them to the government. It was chiefly through the sale of French holdings of foreign securities that the French government was able to acquire the foreign exchange with which to pay the five billion franc indemnity to the German government at the close of the Franco-Prussian War. In the first World War, the British government was able to acquire large foreign balances with which to purchase war materials in the United States by mobilizing the foreign assets of her nationals and selling them abroad. The British owners of these securities were given the option of surrendering their securities to the government in exchange for government bonds or of paying an additional income tax of 10 per cent on the income therefrom. Italy made a similar mobilization and foreign sale of the foreign securities owned by her nationals during the Ethiopian War of 1935-1936, Japan resorted to similar tactics during the "China Incident" which began in 1937, and in 1939-1940 Great Britain again called upon her people to sacrifice a long list of American stocks and bonds in order to obtain foreign exchange for her war against Germany.

The countries that have had the greatest difficulty in inducing their subjects to surrender their foreign exchange to the official agency have been those which over a period of years have tried to maintain the value of their currency well above the rate that would have existed in an unrestricted market and have been least successful in adjusting their price structure to the world price structure, either through currency depreciation or through devaluation. An overvalued currency or a high domestic price structure tends to restrict exports and at the same time to make purchases abroad more attractive. These forces operate to maintain high black market prices for foreign currencies.

The common method of restricting the demand for foreign exchange has been to require permits from the central bank, or exchange authorities, for all purchases of exchange. The first aim of such a permit system is, as has been previously explained, to prevent speculative pressure against the country's currency and to control exports of capital. The control of capital-exports involves,

in addition to the prohibition of the sale of exchange for capital export, a ban on flotations of foreign securities in the domestic market. But the prevention of all exports of capital is a task of the utmost difficulty, as our preceding discussion of the control of the supply of exchange has implied. The purchase of exchange is not the only way by which capital may be taken out of the country. Currency, precious metals, or jewels may be carried out by travelers or by mail; goods may be exported, and the proceeds from the sale left abroad; or the domestic bank account of a foreigner may be transferred to some exporter and used to pay an obligation which would otherwise have brought an increase in the country's supply of foreign exchange. All such practices must be prohibited, or narrowly regulated, if the export of capital is to be brought under effective control. To this end, the amount of wealth that travelers have been allowed to carry abroad has been restricted. Applications for exchange from importers have had to be accompanied by invoices which have been carefully checked to make sure that imports were not overvalued. Some countries have even set up a strict censorship of the mails in order to catch attempts at smuggling currency out of the country. Embargoes upon imports of domestic bank notes have also tended to discourage exports of currency.<sup>3</sup>

Once the flight of capital has been brought under control, other serious problems face the exchange authorities. Chief among these is the allocation of the limited supplies of foreign exchange among the various types of applicants. Wide possibilities of discrimination among the uses, firms, and countries exist. First of all, the desire to maintain essential imports has led to standstill agreements and transfer moratoria on foreign debts. The former involve agreements on the part of foreign creditors to permit temporary non-payment of their credits. To avoid complete default on debt service, transfer moratoria have been arranged, according to which sums owed on foreign debts have been paid in national currency into blocked accounts. Funds in these blocked accounts have sometimes been avail-

<sup>3</sup> The United States Foreign Funds Control during the second World War impounded all United States currency imported, except in those cases where the importer could prove that the currency did not have an Axis origin—a feat almost impossible of proof.

## 468 International Trade and Commercial Policy

able for the purchase of general exports; at other times their use has been narrowly restricted. Payments for current imports are usually given universal preference over payments for past commercial debts. Furthermore, the servicing of private foreign debts has received less favorable treatment than the servicing of public foreign debts. Finally, where supplies of available exchange have been inadequate to pay for current imports, some countries have prorated the available exchange so that each importer has received only a portion of his application. This has resulted in a rapid accumulation of frozen commercial debts and has affected trade disastrously, since it has tied up more and more of the working capital of foreign exporters.

Preferential treatment in the allocation of exchange, which is an inherent feature of any rigid system of exchange control, makes easy the perversion of the entire system from a weapon of defense to a weapon of aggressive commercial policy. Exchange control became one of the basic pillars of totalitarianism.

The first step usually comes in the innocuous form of favoring necessities against luxuries in rationing out *devisen* for imports. From this departure from purely monetary operations, the way leads by easy stages to discrimination against imports of finished products, to favoring imports needed in *Planwirtschaft* and rearmament programs, to shameless partisanship regarding particular vested interests at home, and finally, in conjunction with the weapon of bilateral clearings, to arbitrary deflections of imports and exports from one country to another as a method of political intimidation or bribery. Exchange control lent itself readily to the designs of commercial and political policy when trade maneuvering by other means was precluded by existing trade agreements.<sup>4</sup>

Allocations by many countries were made with the view of bringing into balance the trade with particular countries; other countries gave preference to imports from countries with which trade balances were most favorable, or which had granted preferential treatment to the exchange-control country. The latter practice was common among Latin American countries. In Germany, the allocation of foreign exchange for the purchase of raw materials became an important part of a scheme for promoting the production of arma-

<sup>4</sup> Howard S. Ellis, *Exchange Control in Central Europe*, Harvard University Press, 1941, p. 6.

ments, ersatz (synthetic materials), and foodstuffs to make the nation self-sufficient in wartime.<sup>5</sup>

### BLOCKED ACCOUNTS

Although exchange control was instituted during a severe transfer crisis, the nations which resorted to exchange control were invariably debtor nations and, in most instances, were also exporters of agricultural products, whose balances of payments were adversely affected by the precipitate decline in agricultural prices. The relaxation of exchange control therefore awaited something more than the mere passing of the crisis. It was dependent upon more fundamental adjustments. The rise in agricultural prices that came with recovery, beginning in 1933, eased somewhat the strain on international-payments balances, and currency depreciation contributed further to the restoration of equilibrium by bringing national price levels into line with world prices. But even the rise in export prices and currency depreciation left many countries with foreign debts so great that any hope of attaining international equilibrium was predicated upon a scaling-down of these foreign obligations. Blocked accounts played a major role in this scaling-down process.

A blocked account may be defined as a sum deposited to the credit of a foreign person or corporation in a domestic bank or credit institution, the spending of which is in some degree restricted by the government. By compelling domestic debtors to pay obligations owed foreigners directly into blocked accounts, and by restricting the uses to which these blocked funds could be put, the international transfer of funds was brought under more direct control by the government, and the danger that debtors would resort to the black market to acquire the foreign exchange with which to pay their debts was minimized. The blocked account also assured that whatever foreign exchange was available would be used for the purchase of essential imports and for whatever other purposes the authorities deemed paramount, including the liquidation of

<sup>5</sup> See Gordon, *op. cit.*, p. 84. In the early phases of exchange control, some nations sought to avoid the charge of discrimination by allotting exchange for imports on the basis of imports during a selected earlier period. In other cases, the allocation of exchange was guided by the desire to maintain the government's revenue from import duties.



## 470 International Trade and Commercial Policy

foreign debts under conditions to be described. Finally, it was discovered that blocked accounts could be utilized as a means for subsidizing exports at the expense of foreign creditors.

The earliest of these blocked accounts grew out of standstill agreements. These, as has already been explained, were agreements between domestic debtors and foreign bankers, whereby the latter agreed to transfer moratoria upon commercial advances for a stipulated period. The first German standstill, made in 1931, provided for a reduction, varying from 5 to 20 per cent, in the debts owed foreign bankers by German commercial houses; payments on these debts were to be made in local currency to German banks for the accounts of the foreign banks. The German banks were required to use these funds paid them by their clients for the purchase of foreign exchange for remittance to the foreign creditors. If the requisite foreign exchange could not be supplied, payment was to be made to the Reichsbank into an account for the foreign creditor, who should be entitled to dispose of his balance as best he could after ninety days.

Provision for further reductions in the advances by foreign banks was made in 1933 under the third German standstill agreement. Sums repaid by German debtors were to be deposited with the Reichsbank and were to be inscribed in a special register, thus giving rise to the so-called "registered" marks. Registered-mark balances were blocked for five years and bore no interest; but they might be invested in certain specified ways: (1) in German shares or bonds, (2) in loans and deposits in Reichsmarks made to any person, firm, or company for a period of not less than one month, or (3) in any other investment which the Reichsbank for the time being chose to permit. Registered marks could, in addition, be sold to persons outside Germany for the payment of expenses incidental to traveling in Germany, for the purchase of "additional" exports,<sup>6</sup> and for such other purposes as the Reichsbank might approve.

But short-term foreign bank credits were not the only source of blocked accounts. Blocked accounts also arose from various kinds of indebtedness not covered by standstill agreements, including

<sup>6</sup> "Additional," or "supplementary," exports were exports which could be profitably made only if the exporter were paid, at least in part, in depreciated marks.

a variety of short-term debts owed non-bank creditors and accounts built up by foreign investors from the proceeds of sales of securities, mortgages, real estate, and other forms of property in the exchange-control countries. The former class included many mercantile debts owed foreign exporters, a type of debt which tended to increase when exchange control was first instituted because importers found it impossible to obtain enough foreign exchange to meet their foreign obligations. The volume of blocked accounts in exchange-control countries was also swollen, in the early years of exchange control, by an accumulation of interest and amortization payments on long-term debts, which, under the terms of transfer moratoria, could not be remitted to the foreign creditors. As time went on, however, a considerable portion of these blocked accounts were either liquidated or converted into long-term investments.<sup>7</sup>

Blocked accounts came to be classified according to either their source or the uses to which they could be put. But they all resembled the registered marks of Germany in that they could be spent only within the exchange-control country and only in ways specified by the government of that country. The uses of certain categories of blocked accounts were more narrowly restricted than the uses of others. Because their uses were restricted, blocked accounts, while they could be sold by the original holders, could be sold only at a discount from the rate for the free currency, and the amount of the discount varied directly with the degree of restriction imposed upon the particular class of mark.<sup>8</sup> The heavy discounts at

<sup>7</sup> For a fuller discussion of the German standstill agreements and blocked marks, see C. R. S. Harris, *Germany's Foreign Indebtedness*, particularly Chs. III and IV.

<sup>8</sup> The following tabulation illustrates the differing degrees of depreciation of the varieties of blocked marks.

Quotations for Certain Important Classes of Blocked German Marks  
December 16, 1938  
(in per cent of free marks)

Credit blocked marks	11% to 12%
Security blocked marks	10% to 11
Emigrants' blocked marks	6%
Assistance marks	60% to 61%
Registered marks	43% to 44%

From Margaret S. Gordon, *Barriers to World Trade*, p. 95. By permission of The Macmillan Company, publishers.

## 472 International Trade and Commercial Policy

which blocked accounts were sold in foreign markets were indicative of the willingness of the owners of these accounts to accept huge current losses rather than be subjected to the risks of having their accounts frozen for a long period of years or the hazards of committing their funds to long-term investments within exchange-control countries.

The anxiety of foreign creditors, which steadily increased among the creditors of Germany as time went on, owing to the growing political unrest and the alarming progress made by the National Socialist party, was ingeniously exploited by the German government for the purpose of stimulating German exports. Where the prices of German goods were so high that foreign importers could not afford to buy them at the official rate of exchange, the foreign importer was permitted to make payment in blocked marks up to a certain percentage of the invoice price. Since blocked marks sold at large discounts abroad, the dollar, sterling, or franc price to the foreign importer was reduced to a level which made the purchase attractive, while the German exporter received his full mark price and was permitted to employ the blocked marks within Germany at their full value without restriction. By this ingenious arrangement, German exports were stimulated, the amount of free foreign exchange at the disposal of the German economy was increased, the nominal parity of the mark was maintained, the German debtor got rid of his foreign obligations, and the foreign creditor succeeded in unfreezing a portion of his blocked German balances—at a substantial loss. In short, German exports were generously subsidized at the expense of foreign creditors.

Another means employed by Germany to stimulate her export trade involved the subsidization of German exports at the expense of Germany's *long-term* creditors. The failure to pay the interest on her foreign debts, a consequence of German exchange restriction, caused the prices of German bonds on foreign security exchanges to decline far below their prices in Germany. Germans were, of course, forbidden to repatriate these bonds; that would have used up precious foreign exchange. But German exporters might be granted permission to devote a part of their foreign exchange receipts from the sale of "additional" exports to the purchase of these depreciated German bonds abroad; the bonds could then be sold in Germany at

a much higher price, for there had been no default in interest payments *within* Germany. The German could therefore afford to export his merchandise at a loss because of the profit on his bond transaction. The subsidy to the German exporter was paid by the foreign creditor, just as it was when German exports were financed by blocked marks. How instrumental these two methods were in reducing Germany's foreign indebtedness is indicated by the decline in her foreign debt from 26.8 billion reichsmarks in 1930 to 10.0 billion reichsmarks in 1938.

The discussion of blocked accounts would be incomplete without some mention of the famous "Aski" marks (*Ausländeronderkonten für Inlandszahlungen*). In the case of Aski mark balances, unlike that of the blocked accounts hitherto described, the foreign exporter knew *in advance* that he would have to accept payment, in whole or in part, in the form of blocked marks, which he, or some compatriot, could use only for the purchase of specified German goods. Aski marks could not be converted into any form of foreign exchange. They could not be used as *general* purchasing power in Germany, but must be spent only for specified classes of goods. And the German goods bought had to be shipped directly to the country whose exports gave birth to the specific Aski marks involved; they could not be shipped to some third country where they could be used to acquire free exchange, for this would tend to reduce Germany's supply of free exchange. In order that the prices of German goods might be made attractive to foreign importers who might use the Aski marks, the prices of the Aski marks had to be kept substantially lower than the prices of official marks. But, obviously, if the foreign exporters were to accept payment for their goods in depreciated Aski marks, they had to receive higher mark prices than they would have had to get had they been paid in the more valuable official marks; otherwise, they would have suffered a loss on their exports.

German foreign exchange policy thus made use of the blocked commercial account not only to stimulate German exports, but also to force upon foreign countries a policy of bilateral settlements, which required that the payments Germany made for her imports from a given country must be used to finance German exports to that country. This policy owed its success largely to the willingness

## **474 International Trade and Commercial Policy**

of many countries that produced raw materials and foodstuffs for export to submit to burdensome exchange restrictions in order to dispose of some of their commodity surpluses in the markets of countries that practiced exchange control, after they had sold all that free-currency countries could, or would, take without undesirable price reductions.

### **MULTIPLE-RATE SYSTEMS IN SOUTH AMERICA**

Exchange-control systems were adopted by several countries of South America. But the foreign exchange controls of South American countries differed in certain respects from those of European countries. In fixing official exchange rates, South American authorities recognized substantial degrees of depreciation and did not attempt to maintain their currencies at their former levels. Dealings on black markets were not seriously interfered with. Exchange restrictions, in effect, merely permitted the acquisition of foreign exchange for essential imports and for government payments at preferential rates.

The exchange-control system of the Argentine Republic offers one of the best examples of a multiple-rate foreign exchange policy. The Argentine system, as it operated from late 1933 up to the outbreak of the war in September, 1939, recognized three different exchange rates. The official buying rate was the rate at which all foreign exchange arising from the export of goods, with minor exceptions, had to be sold to the central bank. After January, 1934, the peso was pegged to the pound sterling at a rate of 15 pesos to the pound, a rate which represented a considerable depreciation of the peso from its predepression parity. The exchange bought by the central bank at the official buying rate was, in turn, sold to importers and others, under an allotment system based on advance permits, at a second rate, the official selling rate, which ranged from 16 to 17 pesos to the pound. The distribution of advance permits was governed by the available supply of foreign exchange. Importers who were unable to secure permits were permitted to buy exchange in the black market at yet a third rate, the free market rate. The black market was thus given official recognition as a free market. Exchange on the black market originated from non-merchandise transactions, from exports of goods not regularly exported in the

past, and from exports to certain neighboring countries. The official exchange market absorbed about 90 per cent of the exchange provided by exports, and furnished payments for the whole of the foreign debt service and for about 83 per cent of Argentine imports.

The Argentine authorities utilized this system of multiple exchange rates for the achievement of certain definite objectives. First, the government used the profit which resulted from the margin between the official buying rate and the official selling rate to pay for the operations of crop-control boards, to meet exchange losses on the service of the national debt, to subsidize exports, and to set up an exchange-equalization fund. Second, the difference between the official rate and the free market rate enabled the government to grant preferential treatment to selected countries, either those with which her balance of trade had been active or those with which she had signed special agreements. Advance permits for the remittance of official exchange to individual countries were issued up to the amount of each country's purchases of Argentine products. Importers who failed to secure advance permits were forced to have recourse to the higher-priced exchange of the free market. In 1935 and 1936, for example, all the imports from the United Kingdom were allotted official exchange, while only 35 per cent of the imports from the United States got permits for official exchange in 1935, and only 46 per cent of the imports from the United States were allotted such permits in 1936. The failure to secure a more generous allotment of official exchange naturally handicapped United States exporters in the Argentine market. Third, exports of Argentine goods that had not been regularly sold abroad in the past were stimulated by permitting exporters of such commodities to sell their exchange at the higher rates prevailing in the free market. Exports of such goods, however, never constituted a very large proportion of Argentina's total exports. Finally, the advance-permits system and the free market were utilized to protect the official rate from balance-of-payments pressure. All short-term capital movements were forced into the free market, so that they exerted no direct pressure upon the official exchange rate. Whenever exports increased and the supply of foreign exchange was enlarged, advance permits could be granted more liberally and the official selling

## 476 International Trade and Commercial Policy

rate could be lowered closer to the official buying rate. Whenever foreign exchange became scarcer, either through an increase in imports or through a decline in exports, advance permits could be granted more sparingly and the selling rate could be raised.<sup>9</sup>

### SOME EFFECTS OF EXCHANGE CONTROL

Since exchange control is invariably the outgrowth of an overvalued currency and a scarcity of foreign exchange, the imposition of exchange control leads directly to a reduction in merchandise imports. The domestic prices of the commodities affected by exchange restrictions will naturally rise if the reduced allotments of exchange result in a reduction in the quantities of the goods that are imported. Heuser discovered from his investigation of exchange control in Europe that commodity prices were considerably higher in countries with exchange restrictions than they were in countries with free foreign exchange markets.<sup>10</sup> The physical volume of imports may not, however, decline as much as the severity of the exchange restrictions of the central bank might lead one to expect, if exchange dealings in the black market are large, or if much trade is carried on under clearing and compensation agreements (discussed in the following chapter).

The maintenance of a higher external value for a country's currency than that justified by relative national price levels tends to discourage exports. This is the reason why countries with exchange restrictions have been compelled to subsidize exports in order to maintain their supply of foreign exchange. An overvalued currency, however, tends to produce windfall profits for importers; for, while the *domestic* prices of restricted goods will rise, there is no reason to expect that exchange control will cause *foreign export* prices to rise. As a matter of fact, the restriction of the export markets for foreign goods by exchange control may cause foreign export prices to fall. Even a rise in the foreign export price need not necessarily reduce the importer's windfall profit if further import restriction permits the domestic price to rise proportionally.

<sup>9</sup> For a fuller discussion of multiple-rate system see Frank A. Southard, Jr., *Foreign Exchange Practice and Policy*, pp. 188-197, and Gordon, *op. cit.*, pp. 102-111.

<sup>10</sup> Heinrich Heuser, *Control of International Trade*, Ch. XIV.

While it is to be expected that exchange restrictions will cause the domestic production of restricted goods to increase—and in the early days of exchange control such an increase in domestic production frequently has taken place—Heuser's study shows that in most cases there has been no lasting increase in *total* domestic production, and that in many cases there has been no *permanent* increase even in the production of the goods that have been restricted. In some countries, the failure of domestic production to increase has been due to restrictions upon the importation of raw materials. But, even where raw material imports have not been curtailed, the demand for particular restricted goods will tend to decrease if the number of restricted goods is large and if the price increases are great. Furthermore, the inevitable decline in exports will cause production in industries catering to export markets to decrease.

Exchange control has tended to increase the profits of certain classes, e.g., organized economic groups which have come in for special consideration in the allocation of foreign exchange; but the increased profits of these classes have been at the expense of the living standards of the rest of the community. Labor's share in the national income has dwindled in many countries with exchange restrictions. Another way in which exchange restrictions have injured the economies of exchange-control countries has been by preventing the inflow of new capital. Since most systems of exchange control have refused to allocate foreign exchange for the payment of interest and dividends on, or the repayment of the principal of, foreign obligations, foreign investors have been unwilling to make new investments in the countries with exchange restrictions. The stoppage of the inflow of foreign capital has had serious consequences for exchange-control countries, for the natural direction of the capital flow had been toward these countries.

The most serious consequence of exchange control has been the distortion of world production. Agricultural nations, unable to dispose of their surpluses or to acquire the foreign exchange with which to buy manufactured goods, began to develop their own industries; industrial nations, faced with a shortage of foreign exchange for the purchase of the products of the soil, fostered a further expansion of their agriculture. Production was thus steered



## 478 International Trade and Commercial Policy

further from the course mapped out by comparative advantage, and the trade which survived the restrictions of exchange control was forced into the artificial channels of bilateralism. Purchases from countries with which trade balances were unfavorable were discouraged, while imports from countries with which trade balances were favorable were encouraged, even though imports from the latter were much more costly than imports from the former. How exchange control led inevitably to clearing and payments agreements is the subject of the next chapter.

### SUMMARY

Exchange restrictions were introduced to meet an emergency—the panicky export of capital. The experience of Austria demonstrated that it was possible to abandon exchange control and yet restore equilibrium in the international accounts through a cautious and gradual currency depreciation; by the middle of 1935, Austria was able to liberate from government control all her international payments except those representing the flight of capital. When, however, a country finds itself with an overvalued currency and is unwilling to accept the alternative of exchange depreciation, it must husband its foreign exchange by direct interference with foreign trade. Such was the course deliberately adopted by Germany. Although Germany had by the middle of 1933 brought capital flight under control and secured relief from the pressure of foreign debts upon her balance of payments through satisfactory arrangements with her foreign creditors, and although economic recovery was by this time clearly under way in western Europe, so that devaluation was practicable, she chose to maintain her currency at its previous parity, even though this necessitated a rigid and comprehensive control over the foreign exchanges. From that time on, any justification of German exchange control on financial and monetary grounds ceased to exist; exchange became, instead, a weapon of commercial policy and one of the basic tools of totalitarianism.

The exigencies of global war compelled nations throughout the world to place all their foreign exchange transactions under government control. One of the major tasks of the transition period is to restore order to internal economies and national currencies so that equilibrium rates of exchange may be established that will permit

the gradual removal of these exchange controls with a minimum of disturbance to internal economies. The restoration of political and economic order to the world cannot, however, be accomplished within a brief period of time. The charter of the International Monetary Fund (discussed in Chapter XXVI) permits the temporary use of exchange control, under the supervision of the Fund, to deal with certain situations, such as a world shortage of some national currency or a persistent withdrawal of capital from some country.

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## *Clearing, Compensation, and Payments Agreements*

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Bilateral clearing agreements grow directly out of exchange control. Indeed, so intimate is the relationship between the two that, according to one writer, it is impossible to imagine the one without the other.<sup>1</sup>

Exchange control solved one of the most urgent problems of the debtor nations, viz., the pressure upon their balance of payments that led to an intolerable external drain on their gold reserves and resulted from the abrupt stoppage of the inflow of foreign capital, the withdrawal of foreign-owned, short-term balances, and the precipitous decline in export prices. Exchange control succeeded in halting the withdrawals of foreign short-term capital and the flight of domestic capital, but only after loopholes in the controls had been effectively plugged by compelling all holders of foreign exchange to sell their holdings to the central bank, thus forcing would-be purchasers of exchange to submit their applications to official scrutiny. For many debtor nations, however, the restoration of international equilibrium required something more than the restriction of capital withdrawals; merchandise imports also had to be controlled. Nations which refused to devalue their currencies and were at the same time unable to deflate their internal prices and costs rapidly enough were compelled to curtail their commodity imports drastically. The inevitable result of the curbing of imports was a decline in exports. The fall in the gold value of sterling in 1931, of the dollar in 1933, and of the French franc in 1936 only served to accentuate the difficulties of debtor and agricultural countries, and

<sup>1</sup> Howard S. Ellis, *Exchange Control in Central Europe*, p. 13.

led to a further restriction of imports. The control of imports through the regulation of foreign exchange permits was also found to be a useful addition to the armory of economic weapons of countries which after 1929 followed a policy of autarchy.

This expanding network of restrictions upon international payments created a situation in which business men and governments were practically forced to seek some means of carrying on trade and making international payments in spite of the foreign exchange restrictions. First, exchange restrictions reduced the flow of international trade to a mere trickle, to the direct injury of exporters in both free-exchange and exchange-control countries and of importers in exchange-control countries. Second, exporters found that they were accumulating frozen balances abroad at a rate so alarming that further exports were not attractive. In countries in which foreign exchange transactions were subject to official control, the available exchange was allocated only for "essential" imports. Payments for less important imports, if permitted at all, had to wait; and frequently no payment at all was forthcoming for such imports. Finally, foreign creditors found themselves estopped from transferring payments which had been made on interest and principal accounts within the exchange-control countries out of those countries.

The impulse to release international trade and international payments from the bonds of exchange restrictions thus sprang from two sources: from foreign creditors, who desired to arrange for some repayments of their international credits, and from importers in the exchange-control countries and exporters in both free-exchange and exchange-control countries, who sought to prevent the termination of their business activities as a result of the blocking of payments by exchange controls. Clearing and payments agreements provided a solution of the desires of international creditors, while compensation, clearing, and payments agreements all offered a solution of the complementary desires of importers and exporters.<sup>2</sup>

While the means devised to meet the impasse of shrinking world

<sup>2</sup> Some countries entered into clearing agreements in order to relieve the pressure on their foreign exchanges and thus protect their monetary reserves. Others sought to balance their imports and exports with each of the countries with which trading was rendered difficult by a shortage of foreign exchange. Gordon, *Barriers to World Trade*, pp. 126-127.

## 482 International Trade and Commercial Policy

trade and accumulating frozen credits exhibit great variations in detail, all such measures were designed to accomplish one of two things. They sought either (1) the elimination of bilateral payments through the foreign exchange market between pairs of countries by means of the offsetting of equivalent obligations, or (2) the control of bilateral payments through the foreign exchange market in order to prevent the accumulation of a net balance owed by one country to another.

### CLEARING AGREEMENTS

Clearing agreements were first suggested at a conference of the Danubian countries in Prague on November 1, 1931, as a means of breaking the trade jam which had developed in the Danubian area by the autumn of 1931, the result of the network of exchange restrictions and the accumulation of frozen commercial credits. Several agreements were concluded in the last two months of 1931, the first that between Switzerland and Austria, and many more were signed in 1932 and in the years following.

Most of these agreements involved either two exchange-control countries or an exchange-control country and a free-exchange, creditor country. Where the agreement involved two exchange-control countries, its object was to permit trade to be conducted in such a way that payments in foreign exchange might be avoided; thus the danger that reserves of foreign exchange and gold, already alarmingly low, might be further reduced was removed. Where the agreement involved an exchange-control country and a free-exchange, creditor country, on the other hand, the agreement was almost always entered into at the instigation of the creditor nation, which sought thereby to collect payment on its commercial and financial credits frozen in the exchange-control country. A creditor nation whose nationals had been unable to collect their frozen claims in a particular exchange-control nation, and whose balance of trade with that nation was passive, was in a position to exert strong pressure upon the debtor nation to devote a part of its receipts of foreign exchange from the creditor to the liquidation of the claims of the nationals of the creditor. A creditor nation whose balance of trade with one of its debtors was active, however, had no means of forcing the debtor to enter into a clearing agreement.

The mechanism of clearing agreements is, in its essentials, simple. Let us suppose that countries A and B have entered into such an agreement, whereby all trade between the two countries becomes subject to the agreement. Then importers in Country A will undertake to pay in their domestic currency to a central clearing office in A (usually the central bank) an amount corresponding to the value of the commodities purchased from Country B; the rate of exchange will be mutually agreed upon and will be written into the clearing agreement. This domestic currency is then used to pay exporters in A for all goods exported to B. The counterpart of the clearing office in Country A is established in Country B. Importers in B pay into this office in their domestic currency an amount equal to the value of all goods imported from A; B exporters are then paid out of this fund for goods exported to A. Exporters in each country are thus paid by importers in their own country. No pressure is exerted against either country's foreign exchanges, for there are no dealings in foreign exchange.

Clearing agreements usually provide also for the use of a part of the in-payments in the creditor country for the liquidation of frozen commercial and financial claims against the debtor country; in fact, creditor countries have ordinarily forced clearing agreements upon debtor nations for the express purpose of securing the payment of these impounded balances. Expenses incidental to the merchandise trade, such as insurance premiums and freight payments, as well as tourists' expenditures, diplomatic expenditures, patent fees, and similar payments, have also sometimes been included in clearing agreements. There has been a growing tendency to provide for service items in clearing agreements, as officials have acquired greater experience in managing these agreements. At the other extreme are clearing agreements which include in the clearing mechanism only a part of the merchandise trade between the countries concerned. The Italo-Bulgarian agreement of January 1, 1933, for instance, applied only to purchases of Bulgarian tobacco by the Italian tobacco monopoly, the proceeds from which were to be used for the liquidation of certain sums owed by Bulgarians to Italian industrial concerns. A clearing agreement may cover only a designated *group* of commodities, payments for all others being made through the normal channels.

## 484 International Trade and Commercial Policy

The duration of clearing agreements has been relatively short—from three months to a year. It has been found desirable to limit the tenure of clearing agreements because of the unstable nature of payments balances between pairs of countries; instability necessitates the frequent adjustment of agreements to changing conditions. Once signed, an agreement is usually automatically renewed unless either country desires to terminate it. Most agreements have been renewed, but revisions have frequently been made upon renewal. Frequently, only the more general features of the compact are prescribed in the formal agreement, while details affecting the trade between the two countries and payments pertaining thereto are left to almost continuous negotiations between the contracting countries. A permanent intergovernmental commission is sometimes appointed to meet once a month, or at some other stated interval, for the purpose of discussing the problems arising out of the agreement.

Clearing agreements normally provide for the payment of domestic exporters in the order in which their foreign debtors (foreign importers) make payment to the foreign clearing office, to the extent that the funds paid into the domestic clearing office by domestic importers permit. The dates when payments into the foreign clearing office are made are known to the domestic clearing office because the two clearing offices notify each other of all payments received under the clearing agreement.

Where clearing agreements provide for the repayment of debts out of the export surplus of the debtor nation to the creditor nation, the question of the allocation of funds among groups of creditors becomes a major issue. The creditor country is frequently tempted to accord somewhat more favorable treatment to commercial creditors than to financial creditors, since the maintenance of the export trade is regarded as vital to the national interest. Priority is sometimes given to specific types of payments. In certain Austrian agreements, for example, no funds whatever were to be allocated for other purposes until payments for tourists' expenditures had been made. In other cases specific obligations have been balanced against one another. Provision is made under some agreements for the allocation of additional sums for debt liquidation, provided creditors agree to reductions in interest rates. Creditor countries often place a part

of the funds available in their clearing accounts at the free disposal of the debtor country. Usually the formal agreement places no limitation upon the disposal of these "free funds"; actually, however, there is a clear understanding that the "free funds" are to be spent in the creditor country.

Imports from clearing countries are not exempt from import quotas. Import quotas, as we have already seen, are designed to limit imports of specified commodities rather than to protect the supply of foreign exchange. The demand for the restriction of specified imports is in no way satiated by the adoption of clearing agreements.

#### EFFECTS OF CLEARING AGREEMENTS UPON BILATERAL TRADE BALANCES

If the clearing agreement is to meet with success in liquidating the blocked claims of the creditor nation in the debtor nation, it is necessary not only that the creditor nation have an import trade balance with the debtor, but that this import balance also be maintained. If a country's imports from the debtor nation just equal the country's exports to the debtor nation, current commercial claims can be liquidated, but there will be no excess of receipts over payments with which to pay past commercial and financial claims. If the creditor nation's exports to the debtor nation exceed her imports from the debtor, the creditor's frozen claims against the debtor will actually *increase*. It is only when the creditor nation's imports from the debtor exceed her exports to the debtor that there will be an excess of in-payments over out-payments on trading account in the clearing office of the creditor nation, out of which debt and interest payments may be made.

Unfortunately, the very operation of the clearing agreement tends to destroy this import balance of the creditor country. There are several reasons for the disappearance of this import balance. In the first place, importers in the exchange-control country tend to increase their purchases from the agreement country, since they no longer face a foreign exchange problem. No permit to purchase foreign exchange with which to pay for imports from the agreement country has to be obtained; payment into the domestic clearing office in domestic currency is all that is necessary. Importers consequently increase their purchases in clearing countries and reduce



## 486 International Trade and Commercial Policy

their purchases in non-clearing countries, even though many of the goods purchased in clearing countries are much more expensive than similar goods in other countries. Frequently, commodities are imported from the agreement country which are ordinarily not imported at all. On the other hand, exporters in the creditor country become more eager to expand their sales to traders in the debtor country, for the clearing agreement eliminates the possibility that their claims in the debtor country may become uncollectible.

A second factor that operates to wipe out the import balance of the creditor country is the overvaluation of the debtor country's currency in the official rate set for the conversion of one currency into the other. When an importer pays for goods from a country with which a clearing agreement is in force, he must meet his obligation by remitting to his clearing office in his own currency, even though the obligation is expressed in the seller's currency or in that of a third country. The amount due the clearing office is determined on the basis of the conversion rate specified in the agreement. This official rate may be the former gold parity, the market rate, or a conventional rate fixed once and for all, or subject to alteration from time to time by agreement. Since the very purpose of exchange control is to maintain at an artificially high level the external value of the currencies of countries with weak currencies, the official conversion rates written into clearing agreements frequently overvalue the currency of the exchange-control country. This official overvaluation of the currency of the exchange-control (debtor) country tends to stimulate imports into that country and to discourage exports.

Another consequence of the artificially high rate of conversion is the encouragement of private compensation transactions; in these transactions, every export deal is matched by an import deal of equal value. These transactions are generally conducted on an uncontrolled exchange-rate basis. If the success of the clearing agreement requires only an equalization of imports and exports, private compensation transactions will not interfere with its successful operation. But, if the success of the clearing agreement presupposes the maintenance of an import balance for the creditor nation, the reduction of a large volume of trade to private compensation transactions may imperil debt liquidation under the agreement.

A third reason for the vanishing of the creditor country's import balance is the evasion of the clearing system by exporters in the exchange-control country. The inducements to evade the clearing system are strong. Because of the artificially high conversion rate set on the local currency in the clearing agreement, direct exports to the agreement country tend to decline; importers in the agreement country find it too expensive to purchase from the exchange-control country many goods which they formerly purchased there. Furthermore, while foreign exchange which may be freely spent in any national market is difficult to acquire, its possession is highly desirable. Free foreign exchange may be used to purchase commodities which either cannot be supplied by agreement countries, or can be purchased elsewhere more cheaply; it also provides a vehicle by which capital may be transferred out of the country. There are several ways by which exporters may evade the clearing system. Exporters in an exchange-control country may sell to firms in the clearing country *indirectly* through firms in a third country, thus acquiring freely disposable exchange on the third country. They may assign fictitiously low invoice values to goods exported to the agreement country, with the understanding that the importer is to pay the difference between the invoice value and the actual value into a bank in his own country to the credit of the exporter. They may ship goods on consignment to branch offices in the importing country, payment to be made to the exporter's account in a bank in the free-exchange country. Or the foreign purchasers may be granted very long terms of credit, in the hope that the foreign exchange situation will improve, or the clearing agreement will be abolished, before the credit becomes payable.

The same forces which have tended to dissipate the adverse trade balances of creditor countries have in some instances led to the accumulation of credit (adverse trade) balances in clearing accounts. Since the successful operation of a clearing agreement depends on the maintenance of a prescribed ratio in the trade between the two countries, and since there is nothing in the clearing mechanism itself to assure the attainment of this ratio, trade authorities in the two countries have tended more and more to manipulate import and export restrictions in order to ensure the desired ratio. Creditor countries have realized that the collection of interest and

## 488 International Trade and Commercial Policy

debts owed them by debtor nations was possible only if they maintained an adverse trade balance with the debtor. Debtor nations, on the other hand, have appreciated that the prompt settlement of commercial debts was an essential condition to the continuance of a thriving trade, and that the servicing and repayment of their financial obligations was indispensable to the preservation of their credit in the capital markets of the world. In order to protect an adverse trade balance, or to liquidate a clearing balance, creditor nations have on occasion actively encouraged imports from their clearing partner, sometimes through relaxing their restrictions on imports. For example, Switzerland in 1933 agreed to liquidate a credit balance in the National Bank of Hungary, which had been built up under the first Swiss-Hungarian agreement, by buying 500,000 quintals of Hungarian grain. In earlier agreements she had agreed to stimulate imports from Hungary. The creditor country may also undertake to preserve its adverse clearing balance by limiting its exports to the clearing partner. In 1937, Yugoslavia decided to restrict her exports to Germany to 90 per cent of her imports from Germany; the remaining 10 per cent of importers' payments into the clearing office was to be applied to the liquidation of the Yugoslavian clearing balance in Germany. Swiss exports to Germany were limited to a value of 13 million francs under the Swiss-German agreement of April 16, 1935.

Exchange-control (debtor) countries, too, have endeavored to make clearing agreements workable by the manipulation of their imports and exports. Imports from clearing countries have been controlled by requiring import permits. Italy undertook, in many of her agreements, to limit imports from clearing countries to a specified percentage of the quantities imported in 1934. The stimulation of exports by bounties has also been quite common. Germany, for example, in June, 1935, imposed a turnover tax of 2 to 3 per cent on domestic sales of industrial products and on the consumption of gas and electricity; the proceeds of the tax were to be used to subsidize exporters. Clearing offices have in some instances been permitted to stimulate exports by setting the rate of exchange below the high official rate.

An arrangement which has become more and more common in clearing agreements is found in the *compensation clause*. This is

merely a section in the agreement that provides for a fixed relationship between the imports of the two countries, from each other. One of the earliest of these clauses, contained in the agreement of July, 1933, between Czechoslovakia and Denmark, provided that Denmark's imports under the agreement should be one and one-half times those of Czechoslovakia. The agreement of September 7, 1934, between Germany and the Belgo-Luxembourg Economic Union called for a trade ratio of 100:62.5 in favor of Germany. An Hungarian-Turkish agreement of 1934 established a 1:1 ratio for the trade between the two countries and fixed a maximum total value for the imports of each country from the other for the following six months. Where a definite trade ratio is agreed upon, one or both countries agree to cooperate through their import control systems. It is obviously impossible to maintain a fixed ratio of trade between two countries without the control of imports by at least one of the countries.

#### GERMAN MANIPULATION OF CLEARING AGREEMENTS IN SOUTHEASTERN EUROPE

The clearing agreement, together with exchange control, became in the hands of Nazi Germany the basis of a new system of international trade—a bilateral system centered on Germany, which was to cripple and finally to virtually destroy the structure of multilateral trade which had been centered on Great Britain. This new German trade policy was first put into operation in the countries of southeastern Europe, and by the time war broke out in 1939 it had profoundly altered the course of international trade in that region. It had as its immediate goal the encouragement of economic interdependence throughout a vast area comprising the German Reich and the entire Danubian and Balkan region. Within this *Grossraumwirtschaft*, the Danubian and Balkan countries were to be developed as important sources of foodstuffs and raw materials, while Germany was to become the sole supplier of manufactured products. The success of the early agreements was attributable to the importance of Germany as a market for the petroleum, ores, tobacco, eggs, fibers, and fruits of southeastern European countries, and to the importance of these countries as outlets for German manufactures.

## 490 International Trade and Commercial Policy

Germany entered into her first clearing agreements with the countries of southeastern Europe in 1932 in an attempt to secure the liquidation of her frozen commercial claims in that region. In the years following, as the drain upon her foreign exchange reserves became more severe, she purchased more and more of her primary products from countries with which she had clearing agreements and less and less from free-exchange countries. As time went on and Nazi policy gradually unfolded, it appeared that German trade with clearing countries was being encouraged less as a means of securing imports without being compelled to acquire foreign exchange than as a policy of making clearing countries economically dependent on Germany and complementary to the German economic system. The commercial agreement of February 21, 1934, with Hungary sought not merely to increase trade between the two nations, but specifically stipulated that Hungary should take steps to increase the production of the particular commodities needed by Germany. The treaty of March, 1939, with Rumania carried elaborate provisions for the development of Rumanian agriculture, forests and forest industries, mining, petroleum, transportation and communications, and other industries which directly or indirectly might serve German needs; German technical experts were to be dispatched to Rumania to collaborate in this broad program of development. Germany's success in reducing the Balkan nations to economic subservients in the brief period before the outbreak of war in 1939 is clearly revealed in the accompanying tables.

One technique which Germany used to encourage trade with the southeastern European countries, within the framework of clearing agreements, was to pay for the products of these countries prices (in their local currencies) higher than those prevailing in world markets. Germany was able to pay such prices without disadvantage to herself because she had succeeded in writing into the clearing agreements an official exchange rate which overvalued the mark. The overvaluation of the mark did not injure German export trade to these countries, as one might have expected that it would, because payments for German imports by German importers were made in marks to the German clearing office, and the Balkan exporters were permitted to use these clearing balances only for the purchase of German goods. The overvaluation of the mark in terms of

**TABLE 7. Percentage of Total Exports of Countries of Southeastern Europe to Germany, Austria, and Czechoslovakia**

Countries	Exports to Germany as a Percentage of Total Exports <sup>a</sup>		Exports to Germany, Austria, and Czechoslovakia as a Percentage of Total Exports
	1929	1938	1938
Bulgaria	30	59 <sup>b</sup>	63.5
Greece	23	38.5	43
Yugoslavia	8.5	36	50
Turkey	13	43	47.5
Hungary <sup>c</sup>	12	28	50
Rumania	28	26.5 <sup>b</sup>	36

<sup>a</sup> Excluding Austria and Sudetenland.

<sup>b</sup> Including trade with Austria.

<sup>c</sup> Excluding free ports.

**TABLE 8. Percentage of Total Imports of Countries of Southeastern Europe from Germany, Austria, and Czechoslovakia**

Countries	Imports from Germany as a Percentage of Total Imports <sup>a</sup>		Imports from Germany, Austria, and Czechoslovakia as a Percentage of Total Imports
	1929	1938	1938
Bulgaria	22	52 <sup>b</sup>	58
Greece	9	29	32
Yugoslavia	16	32.5	50
Turkey	15	47	51
Hungary <sup>c</sup>	20	30	48
Rumania	24	37 <sup>b</sup>	50

Source: League of Nations, *World Economic Survey, 1938-39*, p. 202.

<sup>a</sup> Excluding Austria and Sudetenland. <sup>b</sup> Including trade with Austria. <sup>c</sup> Excluding free ports.

southeastern European currencies did, however, injure the trade of the Balkan countries by destroying the market for Balkan products in third (free-exchange) countries. The latter were able to purchase competitive products at prices well below those which the Germans, with their overvalued mark, were willing to pay for Balkan goods.

## 492 International Trade and Commercial Policy

Germany on occasion bought from the Balkan countries, under clearing agreements, goods in excess of her own needs and sold these goods in third countries at prices lower than those at which the countries of origin could afford to sell them; in this way Germany acquired much-desired free foreign exchange, while the countries of origin built up large clearing balances in Berlin because they could not obtain in Germany any goods that they wanted. The inability of the countries of southeastern Europe to acquire free exchange made it impossible for these countries to service or to repay their debts to third countries.

The accumulation of large clearing balances in Berlin and their inability to secure free exchange proved to be sources of considerable inconvenience to the Balkan countries. For one thing, they were unable to buy needed materials from third countries. They were unable, furthermore, to liquidate their clearing balances in Germany except through the purchase of unneeded, and sometimes useless, goods in Germany. In order to liquidate its Berlin balance, one country purchased several carloads of aspirin from Germany; another country accepted a large quantity of German cameras—without lenses. Because the funds paid into their domestic clearing offices were insufficient to pay their importers in full, several of these countries had to make advances to their exporters through their central banks. The German practice of granting long-term credits to importers in the countries of southeastern Europe in order to stimulate German exports also forced the governments of those countries to make advances to their own exporters, since imports gave rise to no corresponding in-payments into the domestic clearing offices. Governments and central banks in the Danube and Balkan region thus rendered involuntary, yet invaluable, assistance in the subsidization of German exports.

The significance of Germany's use of exchange control and clearing agreements has been admirably summarized by Professor J. B. Condliffe:

The ultimate explanation of the new trading devices . . . is political rather than economic, and the most serious criticisms of it from the point of view of the small countries derive from its political implications. Apart altogether from the use made by the German government of its enhanced power vis-à-vis the smaller countries or vis-à-vis other great powers, it is

evident that anything approaching monopolistic German domination of the markets of southeastern Europe may well reduce the bargaining advantages they have enjoyed in the past. It had, even before the war, impaired their economic sovereignty by forcing them to accept a measure of German advice and control in the organization of their economic activity and by necessitating their acceptance of economic regulation modeled upon and fitted into the system. It would not require much extension of such domination to impair their political independence and place them in a position of economic satellites dependent upon, and serving the purpose of, the German market upon Germany's own terms.<sup>3</sup>

Before the outbreak of war in 1939, several of the countries of southeastern Europe had taken action to bring their exports and imports under stricter control in order to prevent the further accumulation of clearing balances in Berlin. Their freedom to map their economic development depended, however, upon the course of German political power, and such freedom vanished completely as a result of the German military and political victories of 1940 and 1941. After the military defeat of Germany in 1945, the Balkan countries, with the exception of Greece, were brought under the political and economic dominance of Russia, which at the present time appears to be reducing them to the status of economic satellites of the powerful neighbor to the north.

### COMPENSATION AGREEMENTS

Another form of bilateral trading agreement that came into common use after 1933 is the compensation agreement. Compensation agreements may be either private or governmental, but the latter have played a relatively unimportant role in international trade, except in the trade of the totalitarian states.

Private compensation transactions are in their basic features the simplest of the new trading devices. They are a refined form of barter. Let us assume that United States wheat is to be exchanged for Brazilian coffee on a private compensation basis. Such a transaction will require the collaboration of four parties: the American exporter, the American importer, the Brazilian exporter, and the

<sup>3</sup> Reprinted from *The Reconstruction of World Trade* by John B. Condliffe, p. 294, by permission of the publishers, W. W. Norton & Company, Inc., New York. Copyright, 1940, by the publishers.



## 494 International Trade and Commercial Policy

Brazilian importer. If a transaction can be arranged whereby the American importer will import Brazilian coffee of a value equivalent to that of the wheat which the American exporter ships to Brazil, an agreement can be concluded under which the American importer pays the American exporter in dollars and the Brazilian importer pays the Brazilian exporter in cruzeiros. Thus the four-sided transaction can be completely liquidated without resorting to any dealings in foreign exchange.

Like clearing agreements, private compensation agreements permit the importation into controlled-exchange countries of goods for which payment through the ordinary channels would not have been allowed. But compensation agreements have one advantage over clearing agreements. They ordinarily grant to the parties to the agreement freedom to determine the conversion rate of the two currencies involved; thus it is possible to export from the exchange-control country goods which it would have been impossible to export at the official rate of exchange. While the importer in the country with the overvalued currency may have to pay a higher price for his imports, under the rate set in the compensation agreement, than he would have had to pay had he been able to buy exchange at the official rate, he can afford to pay this premium if imports of the commodity are restricted because the domestic price will tend to be higher than the world price. In the absence of the compensation agreement, the importer might not have been able to procure the foreign exchange requisite to the importation of the commodity.

Trade under compensation agreements, however, encounters certain obstacles that are not present in dealings under clearing agreements. In the first place, it is no simple matter to find the four partners to a transaction which involves an equality in value of imports and exports in two different countries. The difficulty of getting four parties, instead of only two, to agree upon prices further complicates the situation. Moreover, the seasonal character of the trade in some commodities places additional obstacles in the way of balancing imports and exports at a given time. Imports of some agricultural products into industrial countries tend to be heavy at certain seasons of the year and light at others, a seasonal movement that is not discernible in the trade of many industrial products. Large firms

have been less handicapped by these difficulties than small firms, which do not have the resources necessary to enter into lengthy and complicated negotiations. But the task of matching imports with exports, or exports with imports, has been somewhat eased for small firms by the development of agencies which act as clearing houses in contacting possible partners to compensation transactions and in balancing, where necessary, a whole series of potential imports against a whole series of potential exports.

Compensation agreements have numerous disadvantages for the controlled-exchange country. One of these disadvantages has been the reduction of the amount of exchange on free-currency countries that has been placed at the disposal of the exchange authorities. Obviously, the larger the proportion of a country's exports that are traded under compensation agreements, the smaller will be the volume of export bills that can be drawn on foreign importers or foreign banks. Some of the earlier compensation agreements permitted the withdrawal of foreign capital by combining security dealings, real estate transfers, and the liquidation of foreign-held, domestic bank balances with commodity exports. Furthermore, the high prices frequently paid for imports brought in under compensation agreements have tended to counteract the efforts of those government agencies entrusted with holding down prices. Lastly, many of the goods imported under compensation agreements have been considered less essential from the standpoint of national welfare than others which could not be imported at all, or could not be imported in sufficient quantities, because of the shortage of free exchange.

To ensure that compensation transactions shall operate in closer harmony with governmental policy, private compensation agreements have been placed under strict government control. Exports on a compensation basis have been permitted only when they could not be made profitably at official exchange rates. Sometimes, lists of goods which could be exported on a compensation basis have been drawn up, or exporters have been required to furnish evidence that they could not export at a profit through the regular channels. Some countries have sanctioned compensation deals only when it could be shown that the imports involved were essential to the domestic economy. A few nations have prohibited compensation transactions with nations with whom their balance of trade was active, or have

## 496 International Trade and Commercial Policy

made such transactions compulsory with nations with whom their trade balance was passive. Compensation transactions have in general been permitted with clearing countries only where it has appeared that they would not interfere with the working of the clearing agreement. Some governments have set the rates of exchange, or fixed the prices of the goods, at which compensation transactions might be carried out, either for the purpose of more effectively controlling their own trade, or out of deference to the wishes of other nations which felt that they were being subjected to a special form of exchange dumping.

Public compensation agreements—the parties to which are governments instead of private firms—are of small importance in international trade because, with the exception of Russia and other totalitarian states, the international commercial transactions of governments are not ordinarily of sufficient size in peacetime to justify the conclusion of such agreements. At the bottom of the great depression, however, governments occasionally entered into compensation agreements in an effort to dispose of agricultural surpluses. The Turkish Ministry of Economy in November, 1932, entered into an arrangement with an Austrian tobacco company whereby the Austrian company agreed to buy, up to the end of June, 1933, Turkish tobacco to the value of twenty million French francs, payable in Austrian merchandise. The Brazilian government concluded an agreement with the Grain Stabilization Corporation and the Bush Terminal Company of New York in August, 1931, for the exchange of 1,275,000 sacks of coffee against 25 million bushels of wheat over an eighteen-months period. During these eighteen months Brazil prohibited the importation of all other wheat. An Anglo-American compensation agreement of June 23, 1939, involved the exchange of 600,000 bales of American raw cotton (valued at 30 million dollars) for British rubber of an equivalent value. In this case, both governments were building up war reserves of needed materials. The German and Italian governments during the 1930's entered into numerous compensation agreements, many of which were with Latin American countries.

A special form of the public compensation agreement involves an extension of credit by one government to another with the under-

standing that repayment shall be made in goods. The German credit of October, 1938, to Poland was made for the purpose of enabling Poland to purchase German machinery and other industrial equipment from Germany, and was to be repaid by exports of Polish agricultural products to Germany.<sup>4</sup>

### PAYMENTS AGREEMENTS

Payments agreements, like clearing agreements, segregate the remittances between the two countries party to the agreement from the main stream of foreign exchange. But, unlike clearing agreements, payments agreements do not disturb the normal procedure of settling international accounts in foreign exchange through the ordinary banking channels. However, the volume of transactions is so controlled under these agreements as to assure that over a period of time a country's international payments and receipts shall be equal; the exchange relationships between the two countries are thus stabilized.

Payments agreements have been arranged most commonly between a free-exchange and a controlled-exchange country. The controlled-exchange country agrees to allocate the foreign exchange derived from its exports to the other country in certain specified ways. First claims upon this foreign exchange are usually reserved for the payment of imports from the free-exchange country. An additional percentage of the controlled-exchange country's foreign exchange receipts is then devoted to the payment of interest and debts owed the free-exchange country and to other specified payments; the residuum may be placed at the free disposal of the free-exchange country. The responsibility for carrying out the provisions of the agreement rests with the controlled-exchange country; the free-exchange country is thus relieved of the task of centralizing its transactions with its agreement partner. Sometimes, however, the agreement provides for the establishment of a commission composed of representatives of the two nations, whose duty it is to supervise the working of the agreement, to recommend changes in the case of unsatisfactory

<sup>4</sup>For a more complete discussion of compensation agreements see Gordon, *op. cit.*, pp. 169-189. The present account owes much to Mrs. Gordon's discussion.

## 498 International Trade and Commercial Policy

developments, and even to cooperate to prevent the evasion of the controlled-exchange country's regulations that compel its exporters to surrender their foreign exchange to the exchange authorities.<sup>5</sup>

The success of a payments agreement depends, as does that of a clearing agreement, upon the maintenance of a fixed ratio of the imports to the exports between the two countries. But, whereas clearing agreements do not provide for a fixed trade ratio, unless a special clause is inserted in the agreement, payments agreements explicitly call for such a ratio. The usual method of controlling the volume of merchandise trade is through import quotas that are fixed in the agreement.

Payments agreements have caused much less friction and have given rise to fewer complaints than have clearing agreements. Free-exchange countries have favored payments agreements because they place the responsibility for carrying out the provisions of an agreement solely upon the controlled-exchange country. Moreover, the tendency for the balance of trade to move against the exchange-control country is much less marked under payments agreements than under clearing agreements. Since imports cannot be acquired without effecting a transfer of foreign exchange, as they can under clearing agreements, exporters in the free-exchange country are paid promptly in foreign exchange through the normal channels, and there is no accumulation of clearing balances in either country. By their very nature, payments agreements tend to sustain a bilateral trade balance which conforms to the objectives of the agreement. While no control is exercised over the *absolute amount* of trade between the two countries, the *ratio* of bilateral trade is rigidly controlled.

Payments agreements have been much less numerous than clearing agreements. The great majority of payments agreements have been between free-exchange countries of western Europe, on the one hand, and controlled-exchange countries in central and south-eastern Europe and Latin America, on the other. The prototype for subsequent payments agreements was the famous Roca-Runciman agreement of May 1, 1933, between Argentina and the United King-

<sup>5</sup> Obviously, the satisfactory working of the agreement requires that all receipts of foreign exchange in the controlled-exchange country shall be turned over to the exchange officials.

dom. By this agreement, Argentina agreed to turn over to the United Kingdom the bulk of the foreign exchange arising from exports to the latter, and the order of priority in which the available exchange was to be allocated among the different uses was specified. A few payments agreements have been concluded between pairs of controlled-exchange countries.

### CONCLUSION

Clearing, compensation, and payments agreements were, like exchange control, first introduced as purely emergency measures. Exchange control enabled debtor countries, in the face of falling export prices, the cessation of capital-inflows, and the flight of foreign and domestic capital, to protect their reserves of gold and foreign currencies without undergoing currency devaluation or internal price deflation. Bilateral clearing agreements in many instances permitted the carrying on of trade and the transfer of debt payments in spite of exchange restrictions. But long before the outbreak of war in 1939, bilateral clearing had ceased to be an emergency device and had become a basic pattern of international trading for many European nations. Very few of these agreements had been jettisoned by September, 1939.

It has already been pointed out that an Axis victory would in all probability have meant the scrapping of the international specialization built upon free foreign exchanges and multilateral trade in favor of a system of international exchange founded upon a vast network of bilateral clearing treaties, controlled from Berlin. Aside from the obvious, and insidious, political implications of an international trade built upon such a foundation, what can be said for it from the economic point of view? How well-founded is the view expressed by one ardent supporter of bilateral clearing that, "Taking a long view, there can be no doubt that Exchange Clearing is the system of the future"?<sup>6</sup>

One very significant effect of clearing agreements has already been noted, viz., the tendency of controlled-exchange countries to increase their purchases from clearing partners at the expense of their trade with non-clearing countries. The broad tendency of the trading system established under clearing agreements is thus to di-

<sup>6</sup> Paul Einzing, *Exchange Control*, Macmillan and Co., Ltd., p. 195.

## 500 International Trade and Commercial Policy

vert international trade from its natural multilateral channels into strictly bilateral channels. The more a country exports to its clearing partners, the less it will have, other things being equal, for export to non-clearing countries, and the smaller will be the purchasing power available to it for spending in these neutral markets. This shortage of freely expendable purchasing power compels clearing countries to acquire more and more of their purchases from clearing countries, even though the supply prices of many goods may be higher in clearing countries than elsewhere. Artificial channels of trade are created which disregard costs. To the extent that purchases are diverted from superior sources of supply to less efficient sources, the mutual advantages of trade are diminished, and levels of income suffer.

But the direct deflection of commodity trade away from the sources of cheapest supply is not the only consequence of the shrinkage of triangular and multiangular trade. The decline of multiangular trade also contributes to the difficulties which debtor countries face in paying, and creditor countries meet in collecting, international debts. Debtor countries frequently pay their debts not through a direct commodity-export surplus with the creditor nation, but through a commodity-export surplus with some third nation, which in turn has an export surplus with the creditor. Any clearing agreement which reduces the export trade of the third nation tends to diminish that nation's purchases from the debtor state, which will then have less foreign exchange with which to pay its debts to the creditor state. The creditor state may consequently find that its receipts on investment account from the debtor have completely dried up. Even if the creditor succeeds in arranging a clearing agreement with the debtor, which will not be easy since it does not have an adverse trade balance with the debtor, the creditor will be able to make collections on interest and principal accounts only by purchasing from the debtor goods which it does not want, or which it can purchase more cheaply elsewhere. In the years prior to 1930, for example, the British Dominions and Colonies made their interest payments to the United Kingdom in considerable part by exporting raw materials to Germany and other European countries. The latter, in turn, exported special manufactured goods to the United Kingdom. This multilateral settlement worked out to the advantage of

all parties concerned. Later, however, the adoption of clearing agreements by many European countries and the extension of imperial preferences throughout the British Commonwealth by the Ottawa agreements of 1932 forced a large volume of trade into bilateral channels, and compelled the United Kingdom to receive its interest payments more largely in the form of direct surpluses from the rest of the British Commonwealth. The substantial gains which had resulted from the multilateral settlement were thus lost, to the disadvantage of all parties concerned.

Another effect of clearing agreements, with their drift toward bilateral trade, is their tendency to depress world prices. Finding their export outlets partially closed as a result of the agreements, countries which are not parties to the agreements are able to export less than formerly and are forced to reduce the prices of those goods which they do export. Smaller exports at lower prices impair the ability of non-clearing, debtor nations to meet their own financial obligations and to purchase goods from other countries.

It is true, as Dr. Paul Einzig has pointed out,<sup>7</sup> that the clearing system enables financially weak debtor countries to buy from each other and from financially strong countries. It is also true that it enables weak and strong countries alike to sell to weak countries and to collect for their sales. But it must be remembered that as a result of the bilateral clearing system purchases from third countries have tended to decline, that in any case some of the trade which takes place under clearing agreements would have occurred in the absence of such agreements.

The claim that the clearing system tends to reduce obstacles to foreign trade, such as exchange restrictions, quotas, prohibitive tariffs, and import embargoes, cannot be substantiated. True, where clearing agreements are in effect, exchange control is rendered unnecessary between clearing partners—but only because the clearing system totally abolishes the foreign exchanges. Clearing agreements are, however, every bit as drastic a form of intervention in foreign trade as the most rigorous exchange control. Where tariffs or quotas have been eased as a result of clearing agreements, they have been

<sup>7</sup> *Op. cit.*, pp. 140–141. For a summary of the merits of the clearing system as expounded by Dr. Einzig and a critical discussion of these views, see P. T. Ellsworth, *International Economics*, pp. 416–419.



## 502 International Trade and Commercial Policy

eased only temporarily, to permit the liquidation of an accumulated clearing balance, not as a permanent policy. The accumulation of future clearing balances has generally been guarded against by an even more rigorous control of foreign trade than that which existed before.

Where a creditor country has had an adverse balance of trade with the debtor country, the clearing system has facilitated the payment of old external debts in the form of exports to the creditor country. But debt collections by creditor nations which have not had an adverse trade balance with their debtors have in no way been facilitated by clearing agreements. The tendency of the clearing system to force trade into bilateral channels has, on the contrary, made the collection of international debts by these less fortunate creditor nations more difficult, if not impossible. The sad experiences of American holders of German bonds in the 1930's is mute testimony to the unhappy rôle of creditors who find themselves in so unfortunate a situation.

Perhaps no fairer appraisal of the clearing system can be made than that which is contained in the following statement of Professor Ellsworth:

. . . it seems safe to conclude that the clearing system has provided an emergency method of meeting the acute situation established by multifarious trade restrictions and exchange controls. As such an emergency remedy, it has permitted the continuance and perhaps under specially favorable conditions the growth of trade between certain selected countries, and has made possible the collection by creditor nations of otherwise unrecoverable claims. The very nature of clearing agreements, however, is such as to strangle triangular trade and to produce a steady trend toward bilateralism, while in practice they have operated to reduce the volume of trade between clearing and non-clearing countries.<sup>8</sup>

It might be added that the clearing system permits the continuance of a certain volume of international trade along specified channels, despite severe trade restrictions and maladjustments between national price levels. However, the gradual reduction, or the com-

<sup>8</sup> P. T. Ellsworth, *International Economics*, p. 419. By permission of The Macmillan Company, publishers.

plete removal, of trade restrictions and the bringing of national price levels into line with world prices through deflation or currency devaluation would accomplish everything that the clearing system accomplishes—and much more. Such policies would pave the way for a great expansion of world trade and would redirect that trade into more economic channels, to the improvement of living standards the world over.

The political dangers inherent in the clearing system cannot be too strongly emphasized. Such a system may cause international trade to degenerate into a chaotic and unregulated form of economic warfare. Where a system of bilateral clearings is adopted by a major power, it may enable that power to exercise economic domination over smaller countries. By purchasing heavily from a small country, the large country may gain something approaching a monopoly over the trade of the former; for the small country will then be obliged to divert a major share of its purchases from other countries to the clearing country in order to liquidate its untransferred credits in its clearing account with the economically powerful country. This economic domination, once achieved, may be used to exert political and economic pressure upon the small country. A sudden boycott of the weaker country by the large country could be disastrous to the latter, while such a curtailment of the trade between the two countries would affect no more than a relatively small part of the total trade of the former.

As long as the commercial policies of nations are motivated by the desire for self-sufficiency, however, the prospects that nations will ease their trade restrictions or will be eager to bring their price structures down to levels which will facilitate world commerce are dim indeed. As long as war is an ever present threat to all nations, that nation is truly daring, perhaps improvident, which seeks to increase its economic dependence upon other nations, even though it realizes that such a policy will enhance its economic welfare. Even the great critic of mercantilism and apostle of free trade, Adam Smith, has remarked that "Defense is more important than opulence." Today, more than ever, the realignment of international economic relationships upon the substantial foundation of comparative advantage depends upon the establishment of a world political or-

## 504 International Trade and Commercial Policy

ganization which will free nations from the ever-threatening specter of war.<sup>9</sup>

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<sup>9</sup> The principle of bilateral clearings has been carried over into the postwar period. Great Britain, for example, has since the war entered into bilateral financial agreements, ranging in duration from three to five years, with most of the countries of western Europe. These agreements provide for the acceptance of sterling by the central banks of the various European countries in settlement of current payments from Britain and the acceptance of local currencies by the Bank of England in settlement of payments in the other direction—both within agreed limits. All the agreements provide that sterling will not be used by European central banks to purchase third currencies without the consent of the Bank of England and that Great Britain and the other party will each take steps to prevent the movements of funds that serve no useful economic purpose. In practice, this means most capital transfers. Under these agreements sterling, up to stated limits, is not convertible into third currencies; only after the limit has been reached will the other party to the agreement be able to buy a third currency with the proceeds of her exports to Britain. These agreements have been criticized as being inconsistent with the Bretton Woods agreement for an International Monetary Fund. *New York Times*, March 18, 1946. France had also, by the end of 1945, concluded a series of bilateral financial and commercial treaties with Great Britain, Spain, Switzerland, Belgium, Denmark, Sweden, Czechoslovakia, and Argentina. These treaties specify what goods shall be exchangeable and fix the amount of credit which the parties to the agreements will grant each other in their own currencies. *Wall Street Journal*, December 3, 1945.

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## *Dumping*

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Our analysis of international trade and discussion of the problems arising from it have up to this point tacitly assumed, in general, that production and trade are carried on under conditions of pure competition, under which prices tend to seek cost (marginal) levels. While conditions approaching those of pure competition do govern considerable sections of production and trade in most countries of the world, large segments of practically all national economies are subject to monopolistic influences, and in some countries, e.g., Soviet Russia, competition can hardly be said to exist. The growing dependence upon capital and the development of mass-production techniques since the Civil War have resulted in the increasing concentration of production in the hands of fewer and fewer producers. Although outright monopoly is not common, competition is far from perfect where differentiation of the product exists, or where production in an industry is concentrated in the hands of a small number of producers. Under such conditions, a greater or lesser degree of monopoly prevails.

The existence of national monopolies and quasi-monopolies has given rise to two specific problems of international trade, viz., dumping and international combinations. National monopolies, particularly where they operate behind protective tariff walls, have frequently found it advantageous to engage in dumping, a practice which has provoked vigorous remonstrances and the adoption of counter-measures on the part of nations into which goods have been dumped. Furthermore, as world production and trade in any article, or group of articles, has come under the control of several national monopolies, or monopolistic groups, competition in export markets

has tended to become more rigorous, and on occasion national monopolies have even invaded each other's domestic territory. Sometimes even governments have taken an active part in national combinations. The instability of prices and profits which has resulted from the economic battles of these giant national monopolies has led almost inevitably to the creation of international combinations or agreements which have sought to maintain prices, divide neutral markets, and preserve domestic markets exclusively for domestic producers.

The present chapter is devoted to an analysis of dumping, the following chapter to a discussion of the problems of international agreements and monopolies.

### THE NATURE OF DUMPING

Dumping is a term which has meant different things to different people. In statements by interested parties, in the press, and in political speeches, it has become a vague term of abuse with which to brand every kind of foreign competition. Domestic producers, for example, have used it to refer to sales of a good in the domestic market by foreign producers at prices lower than prices prevailing there, or to sales by foreign producers in the home market at prices with which domestic producers cannot compete. Sometimes it has been applied to sales in the domestic market by foreign producers at prices below average costs of production abroad. Fortunately, economists are now in general agreement as to what constitutes dumping, and unhesitatingly accept Professor Viner's definition of it as "price discrimination between purchasers in different national markets." More commonly, the term is given a narrower meaning than this, and refers to sales of a good to foreign purchasers at a price lower than the price of identical goods to domestic purchasers.

The two definitions are not inconsistent; Professor Viner's definition is merely broader than the other. Sales abroad at prices below those charged to domestic buyers are obviously one form of price discrimination between different national markets. But there are other forms of such discrimination. Where there is no domestic market, there may nevertheless be price discrimination between purchasers in different export markets. And the dumping ground may be the home market, sales to foreign purchasers being made at

## 508 International Trade and Commercial Policy

higher prices than those to domestic purchasers (reverse dumping).<sup>1</sup> Viner's definition obviously includes all three aspects of dumping. Since principal concern has been over sales for export at prices lower than those charged to domestic buyers, this narrower meaning of the term will be employed in the present discussion.

Proper identification of dumping requires that the goods sold abroad and those sold in the domestic market, and the terms of export sales and those of domestic sales, be identical in all respects. If they are not, then anti-dumping measures may be invoked against "spurious" dumping. Lower export prices are not evidence of dumping if they merely reflect differences in the size of orders as between the export and domestic markets, differences in the terms of credit or in the credit ratings of buyers, the poorer quality of export goods, or differences in packaging requirements. The choice of the time to which the price comparison refers is particularly important. The proper time is the moment when the sales contract is concluded. If the comparison is made at the date when the goods cross the frontier, as is provided in the anti-dumping laws of some countries, anti-dumping measures may be incorrectly applied. For, if home prices rise between the date of purchase and the date of export, dumping will be ruled where no dumping exists; whereas, if prices fall in the interim, actual dumping may go undetected. Lower prices on exports than on domestic sales do not indicate dumping if the difference simply measures a drawback of previously paid import duties on the article or on materials embodied in the article. Likewise, dumping is not indicated if export sales are exempt from the payment of internal excise taxes which are levied on all domestic sales.

On the other hand, general dumping may be concealed by divers practices. The prices to purchasers in different markets may be identical, although the conditions and terms of sale differ. Secrecy of export prices may be maintained. Minute amounts of the product may be sold in distant and isolated sections of the home market at low prices, equivalent to export prices, while the bulk of domestic sales is made at substantially higher prices. Identical types of the

<sup>1</sup> Reverse dumping is not common. It might take place if the main market were abroad, the domestic market being a subsidiary one. Or it might be found where a domestic monopoly followed a restrained price policy at home because of the fear of hostile legislation or popular resentment.

goods exported may not be sold in the home market, thus making price comparison difficult. Finally, goods destined for the export market may not be sold prior to shipment, but may instead be shipped on consignment and later sold abroad at prices below those prevailing in the home market.

The sale of goods in foreign markets below the costs of domestic producers in those markets is clearly not dumping; it is indicative merely of rigorous foreign competition and probably of a comparative advantage in those particular lines of production on the part of the export country. Neither are sales abroad at prices below average cost of production necessarily dumping, since in times of depression both domestic and foreign sales are frequently made at below cost prices.<sup>2</sup> So-called "exchange dumping," i.e., foreign sales by a country whose foreign exchanges are depreciating more rapidly than its internal prices and costs are rising, is probably in almost all cases a misnomer. Frequently, the f.o.b. price for exports is the same in countries with depreciating currencies as for domestic sales; in many instances, manufacturers in such countries have charged much higher prices in terms of their own currency for the goods for export than they have for goods sold in the domestic market (reverse dumping).<sup>3</sup> In summary, dumping occurs whenever the f.o.b. factory or warehouse price is lower for export than for domestic sale, after reasonable allowance for any differences in the conditions or terms of sale.

#### KINDS OF DUMPING; MOTIVES FOR DUMPING

Professor Viner classifies dumping into three main categories according to the duration of the dumping: (1) sporadic, or occasional, (2) short-run, or intermittent, and (3) long-run, or continuous.<sup>4</sup> Sporadic dumping is a means of disposing of casual overstocks or "remainders" at the end of a selling season, which may be practically unsaleable on the home market. Curtailment of production while

<sup>2</sup> Long-continued export sales below average costs of production, however, may well mean dumping. But see the section on the Theory of the Dumping Price later in this chapter.

<sup>3</sup> The anti-dumping laws of some countries, for example, Australia and South Africa, provide penalties against "freight dumping," i.e., the importation of goods charged freight rates below the prevailing rates at the date of shipment.

<sup>4</sup> *Dumping: A Problem of International Trade*, p. 23.



## 510 International Trade and Commercial Policy

overstocks are being worked off at unchanged prices may not be desirable, and reduction of prices on the home market may appear unwise because of its possibly unfavorable effects upon consumers' attitudes toward prices. Sometimes, furthermore, a shipment of goods must be disposed of in a foreign market for what it will bring when the consignee rejects the shipment or fails to live up to his contract.

Short-run dumping exists when from time to time, over short periods, a producer sells abroad at prices lower than he charges to domestic buyers. It may be resorted to in order (1) to maintain connections in a market in which prices are for the time being and on remaining considerations unacceptable; (2) to develop trade connections and build up buyers' goodwill in a new market; (3) to prevent the loss of a foreign market through temporary underselling by foreign competitors; (4) to eliminate competition in the market dumped on by either destroying competitors or "rendering them amenable to the wishes of the dumper"; (5) to forestall the establishment of rival sellers in the foreign market;<sup>5</sup> or (6) to retaliate against dumping in the reverse direction (defensive dumping). Short-run dumping may involve selling at a loss, in the sense of selling below marginal cost or even below average variable cost, which may be lower than marginal cost.

Long-run (continuous) dumping, on the other hand, means selling year in and year out at lower prices abroad than to domestic purchasers. Continuous dumping can take place under conditions of competition only when the government or some other body grants a bounty on exports. Under monopoly conditions, it will not take place at a loss, that is, foreign sales will not be made at a price below marginal cost. It can be undertaken at a profit under monopolistic conditions (1) if export permits existing plant to be more fully utilized, i.e., utilized closer to optimum capacity, or (2) if export permits such an enlargement of plant as will realize lower costs of production. When long-run dumping is practiced under conditions of imperfect competition, the export price must at least cover marginal cost, while the home price must remain *above* marginal cost. The dumping of the great trusts and cartels is usually of this long-run

<sup>5</sup> Short-run dumping is called "predatory" when it is employed to eliminate or prevent the establishment of competition.

type. Long-run dumping which depends upon the payment of an export bounty by the government (usually by industries operating under conditions of pure competition) generally rests upon mercantilistic grounds, the belief that exports in themselves are beneficial to a nation or that the domestic development of certain industries is desirable.

### CONDITIONS NECESSARY FOR DUMPING

If dumping is to be successfully carried on, it is absolutely essential that the dumped articles be prevented from being sold back into the domestic market. Otherwise, domestic purchasers would buy on the cheaper foreign market and producers would find it impossible to sell any amount whatsoever on the domestic market at the higher prices listed for domestic purchasers.<sup>6</sup> Transport costs constitute one obstacle to shipping dumped goods back into the country of origin. Dumpers can be sure that purchasers in the country dumped on will not find it profitable to resell the dumped goods in the country of origin if the difference between the home and the foreign price does not exceed the sum of the transport costs out plus the transport costs back into the home country. The more bulky the goods, the greater is this obstacle likely to be. Sometimes the dumpers prevent the return of the dumped articles by compelling foreign purchasers to sign an agreement not to resell the goods in the home market. But the most important means of preventing the return to the home market of goods dumped abroad is an import duty. Protective tariffs and transport costs combined form a very effective safeguard against the possible return sale of dumped goods.<sup>7</sup>

In the absence of a bounty, continuous dumping can occur only when, in addition to assurance against resale in the home market, production takes place under monopoly conditions. Where competition is keen (pure), no producer will find it to his advantage to sell abroad at prices below home prices. To do so would only reduce his

<sup>6</sup>This condition is indispensable to *all* price discrimination, of which dumping is merely one form. Railways are able to charge higher rates for transporting dry goods than for transporting coal only because shippers who purchase railroad service for coal cannot turn around and sell that same service to anybody else for some other use. Hauling coal completely consumes that particular service.

<sup>7</sup>English industries have engaged in dumping without receiving any tariff protection, depending only upon the protection of transport costs.

## 512 International Trade and Commercial Policy

total income, to the profit of his competitors. Each producer will sell in that market where prices are highest, and, as long as prices are higher at home than abroad, no sales will be made abroad. A monopolist, however, can maintain prices in the home market while he dumps at lower prices abroad. Even if production is not under the control of a single producer or a trust or syndicate, the existence of only a few producers who consider the probable effects of their own price policies upon those of their competitors or of product differentiation may assure that degree of price maintenance at home which makes dumping feasible. It is instructive that dumping has occurred most frequently in such fields as iron and steel products, agricultural machinery, and petroleum products, industries characterized by monopoly or oligopoly (few sellers). Dumping of agricultural commodities rarely occurs, except when stimulated by government export bounties, primarily because agriculture is usually organized on the basis of small-scale production by many individual farmers.<sup>8</sup>

### EFFECTS OF DUMPING ON PRICES IN THE DUMPING COUNTRY

Domestic consumers frequently complain that selling to foreigners at low dumping prices means higher prices to domestic consumers and that this is contrary to a sound national policy. Now if dumping makes possible lower domestic prices than would otherwise result, consumers are benefited and there is no offsetting disadvantage to be considered. If, on the contrary, dumping causes domestic prices to rise, domestic consumers are injured; but this may not mean a national loss if the profits of the monopolist are increased by an amount equal to the loss in consumers' surplus. Even though the loss to consumers in the form of higher prices is counterbalanced by an increase in monopoly profits, however, the resultant increased inequality in the distribution of income may be undesirable from the viewpoint of public policy. But this is true of *any* monopoly which is permitted to reap monopoly profits, regardless of whether

<sup>8</sup> It is agricultural commodities, however, which are the most frequent recipients of government bounties, and on occasion an agricultural industry has been able to organize itself sufficiently to establish export bounties. The disposal of surpluses abroad at dumping prices has been a prominent feature of certain schemes for farm relief in the United States in recent decades—for example, the McNary-Haugen plans of the 1920's.

or not it practices dumping. It is monopoly *per se* which is harmful, and if the monopoly could be effectively destroyed by state action, a more economic allocation of the factors of production and a more equal distribution of income would result. Nevertheless, dumping itself may or may not be injurious to the dumping country, and in order to ascertain whether it is or not it is necessary to study its effects upon domestic prices.

If the dumped goods are not produced to be dumped, but are disposed of abroad merely to get rid of a casual overstock, domestic consumers suffer in that they are deprived of a bargain sale. Obviously, this case is not of great practical importance. If the dumping is short-run in nature and is engaged in to establish the producer in a new market or to hold his position in an old foreign market against new competition, it is doubtful if domestic consumers are injured. For it is unlikely that the producer will risk incurring the wrath of domestic consumers and of possibly inciting regulative legislation by raising domestic prices, particularly since he will regard the low foreign prices, which may or may not be below cost, as only temporary and will consider them to be the cost to him of establishing himself in the foreign market.

In the more important case of long-run dumping, dumping by a national monopoly may under certain circumstances be not only a prudent business practice from the point of view of the monopolist, but may also result in lower prices to domestic consumers.<sup>9</sup> In accordance with the principle of discriminatory monopoly price (charging what the traffic will bear), the monopolist will realize his maximum profits when he has expanded his output up to that point at which marginal costs for output as a whole, marginal revenue from domestic sales, and marginal revenue from export sales are all equal to one another. Where at the point of equilibrium the elasticity of demand is identical in the two markets, prices in the two markets will be the same. But such a coincidence is unlikely. For, although the exporter has a monopoly in his home market, he will in all likelihood have to face competing sellers in the foreign market, so that the foreign demand for his product will be more

<sup>9</sup> This analysis also applies to "trade-cycle dumping," dumping which takes place in periods of depression when the home demand falls off to such an extent that home sales are not sufficient to keep the concern operating at full capacity.

## 514 International Trade and Commercial Policy

elastic than the domestic demand, and the foreign maximum revenue price will therefore be lower than the domestic. Whether dumping at lower prices abroad will cause the domestic price to rise or to fall will depend upon the trend of the monopolist's marginal costs over the relevant range of output. If marginal costs are rising, resort to dumping, with a consequent increase in output, will lead to a higher domestic price than if dumping did not occur; if marginal costs are, on the other hand, falling, dumping will lead to a lower domestic price. In either case, the monopolist will realize higher profits than if he did not dump.<sup>10</sup>

These conclusions can be best elucidated by means of a diagram. First, however, it will be necessary briefly to develop the theory of monopoly price.

*The Theory of Monopoly Price.* Every producer wishes to maximize his profits, or minimize his losses, regardless of whether he is a monopolist or operates under conditions of competition. Under conditions of pure competition, that is (1) where the product is completely standardized so that any unit of a given grade is perfectly interchangeable with any other unit and buyers choose between sellers solely on a price basis, and (2) where the number of sellers is so great that variations in the offerings of any one seller have a negligible effect upon the total supply and the market as a whole, a price tends to be established which equates the quantity offered and the quantity taken at a level equal to the minimum average unit costs of the marginal producer. No seller can get a higher price than this, for at any higher price buyers will refuse to patronize him. Nor will it avail any seller to restrict his offerings in the hope that he can then charge a higher price, because he contributes such an infinitesimal fraction of the total supply that the withdrawal of his entire offerings would not perceptibly affect the market price. Any price higher than this equilibrium price, furthermore, cannot long endure; such a price would yield producers profits in excess of competitive profits, and these windfall profits would in turn encourage old firms to expand their output and would attract

<sup>10</sup> The *dumping* price, too, will be affected by the trend of marginal costs. The volume and elasticity of foreign demand will also influence the dumping price, foreign demand depending not only upon the desires of foreign consumers but upon the intensity of competition in the foreign market as well.

new enterprise into the field. Output would continue to increase until the increased quantity offered had forced the price down to the equilibrium level again. Conversely, any price lower than the equilibrium price cannot persist indefinitely. For this would mean operating at a loss for at least some of the firms, and losses would sooner or later force the weaker firms to cease operations, with a consequent reduction in total output and an increase in price. Operations in the industry could not be stabilized until enough firms had been forced out of business to force the price up to that level which just covers the average total unit costs of the marginal producer at his optimum output.<sup>11</sup>

<sup>11</sup> This situation may be illustrated by diagrams.

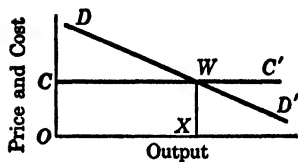


FIGURE A.

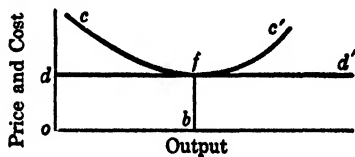


FIGURE B.

The total demand for a given commodity is represented in Figure A by  $DD'$  and the cost curve for the entire industry by  $CC'$ . Price will settle at  $XW$ . The demand and cost situation facing an individual firm in the industry may be represented by another diagram, Figure B. The firm's demand curve is represented by a horizontal line,  $dd'$ , since the firm's output constitutes such a small part of the total output that any change in the former's output will not affect the price. The firm's curve of average unit costs is depicted by  $cc'$ , and includes a minimum profit. The output scale of the firm, Figure B, will be much smaller than that of the industry, Figure A.

Obviously, the marginal producer will maximize his profits by producing an output ( $ob$ ) for which his average unit costs are a minimum ( $bf$ ). For any output greater or smaller than this, his average costs will exceed the market price, and the producer will suffer losses. Firms whose cost curve is higher than  $cc'$  would suffer losses even at a price of  $od$  and would be forced out of business; firms whose cost curve is lower than  $cc'$  would find it profitable to produce a quantity somewhat greater than  $ob$ . No other price than  $OC$  ( $od$ ) can persist. Were the price higher, output of the industry would expand and the price would fall; were the price lower than  $OC$ , output would be contracted and the price would rise. At a price of  $OC$  there will be no inducement for firms to expand their output or for new firms to enter the industry, and no pressure for firms to reduce their output or abandon the industry.

For a more complete analysis of price under conditions of pure competition see Albert L. Meyers, *Modern Economics: Elements and Problems* (1941), Chs. VIII, XII, XIII; or John Ise, *Economics* (1946), Chs. XV-XVI.

## 516 International Trade and Commercial Policy

In brief, to the individual producer under conditions of pure competition, the market price is a datum. No individual action of his can change it; he can only try to adapt his operations to it. His best policy is to carry his output up to that point at which his marginal costs equal market price. If at that point his total average costs are not covered, he suffers a loss and must go out of business, unless the price rises before his cash resources are entirely exhausted. With no other output will he fare as well.

The monopolist is more fortunate. Being the sole seller in the field and having no close competitors, he is free to set whatever price he chooses. But, once his price has been fixed, he cannot sell any quantity he chooses; his sales are limited by demand. His position in this respect is unlike that of the individual producer operating under the conditions of perfect competition; the latter may sell at the market price *any* volume within his productive capacity. In technical terms, the demand curve of the seller under pure competition is a horizontal line, that of the monopolist a sloping line. If the monopolist prefers, he may fix the quantity which he will sell; but in that case he must accept the price at which the market will just absorb that quantity. In short, he may set *either* the price *or* the quantity, as he sees fit, but he cannot set both.

The price which the monopolist will set, or the quantity he will decide to place on the market, will be such that his total receipts (quantity sold times the price) minus his total costs is a maximum. This optimum output, or maximum-profit price, is attained when marginal costs, that is, the amount by which total costs are increased by the production of one unit more, equal marginal revenue, that is, the amount by which total revenue is augmented by the sale of one unit more.<sup>12</sup> This means that the monopoly price is established and

<sup>12</sup> Simple examples may help to clarify the concepts of marginal cost and marginal revenue. Suppose that

40 units can be sold at a price of \$80, yielding total revenue of \$3200

41 units can be sold at a price of \$79, yielding total revenue of 3239

Difference = marginal revenue \$ 39

The marginal revenue at that point will then be \$39, the amount by which total revenue is raised when 41 instead of only 40 units are sold. Note that marginal revenue is less than price in this case.

Suppose next that 10 units can be produced at a total cost of \$50, and 11 units at a cost of \$53. By producing 11 instead of 10 units total costs have been increased by \$3. This is the marginal cost.

the monopolist's maximum profit realized when output is such that any increase in output would add more to costs than it would add to receipts, or any decrease in output would subtract more from receipts than it would subtract from costs. This conclusion may best be illustrated with the aid of a diagram.

In Figure 6,  $DD$  represents the demand curve and  $MR$  the marginal revenue curve derived from this demand curve. Since the demand curve slopes downward to the right, indicating that larger quantities can be sold only at lower prices than smaller quantities, the marginal revenue curve lies below the demand curve and is more steeply inclined. Average total unit costs are depicted by the curve  $AC$  and marginal costs by  $M'C'$ , which declines steadily to the point of diminishing marginal returns and thereafter rises. Clearly, the most favorable quantity to produce is  $OB$ , which can be sold at the price  $BP$ , for at this output marginal costs equal marginal revenue. Total receipts are represented by the rectangle  $OWPB$ , or by the area which lies below the marginal revenue curve, i.e.,  $OMTB$ . Total costs are represented by the rectangle  $OSQB$ , and monopoly profits by the rectangle  $SWPQ$ . At the price  $BP$ , monopoly profits are a maximum. For any output smaller than  $OB$ , or any price higher than  $BP$ , any increase in output would add more to revenue than it would to costs and thus add to total profits, since to the left of  $T$  the marginal cost curve always lies below the marginal revenue curve. For any output greater than  $OB$ , or any price lower than  $BP$ , a decrease in output would subtract more from costs than it would from revenue and thus enhance total profits, since to the right of the intersection  $T$  the marginal cost curve lies continuously above the marginal revenue curve.<sup>18</sup>

It will be observed that under monopoly the equilibrium output ( $OB$ ) is less than the optimum, or lowest average cost, output ( $OF$ ), and that the equilibrium price ( $BP$ ) exceeds both average costs ( $BQ$ ) and marginal costs ( $BT$ ). Under imperfect competition—differentiated product or few producers—price will be above marginal costs and each firm will operate short of optimum capacity.

<sup>18</sup> The price  $BP$  is the price which will yield the monopolist the greatest profit. Inertia, the fear of public regulation, or the possibility of inducing the introduction of substitutes, however, may temper the monopolist's price policy and cause him to forego a portion of his potential profits.



## 518 International Trade and Commercial Policy

But price will tend to remain above average cost only when there are restrictions on the free entry of firms into the industry. Under pure competition, on the other hand, marginal firms would expand output to  $OF$ , while competition would force the price down to  $FH$ ,

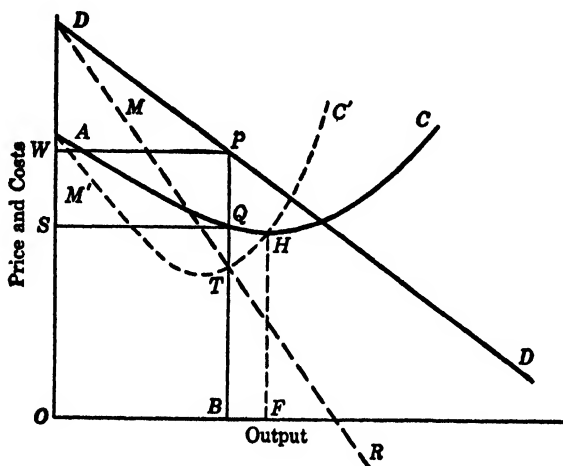


FIGURE 6.

lowest total average unit costs.<sup>14</sup> Prices thus tend to be higher and output smaller under conditions of monopoly and imperfect competition than under pure competition.

*Theory of the Dumping Price.* The preceding section has analyzed the determination of monopoly price in a closed monopoly market. Where export is possible, the monopolist has two markets in which he may sell, and, because they are separated by transport costs and possibly import duties, in which he may sell at different prices. Even in this situation, however, he will seek the same goal as in the closed monopoly market, namely, to maximize his profits or to minimize his losses. If the foreign price is equal to, or higher than, the monopoly price in the home market, dumping is unnecessary; the monopolist will simply expand his output up to the point where

<sup>14</sup> Where, under pure competition, uniform costs do not prevail, infirmal firms will find it profitable to expand production *beyond* the optimum point, and their average costs will be somewhat lower than price—unless the opportunity costs for superior entrepreneurs are included in costs, in which case the average costs of all firms would equal the price for the product.

his marginal cost equals the foreign price.<sup>15</sup> If, however, the foreign price is lower than the home monopoly price, the monopolist must dump if he wishes to sell abroad.

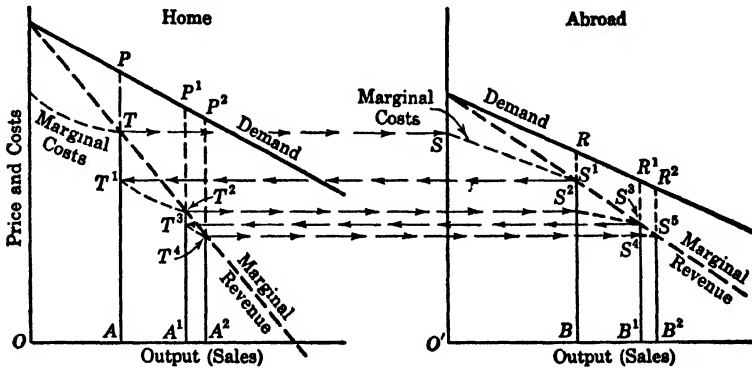


FIGURE 7.

Let us consider first the case in which the monopolist's marginal costs decline for a considerable volume of output beyond that which can be sold at the closed monopoly price in the home market. This falling marginal cost curve is shown in Figure 7, along with the demand curves in the home and foreign markets and the respective marginal revenue curves derived therefrom. The marginal cost curve is presented in segments distributed between the two markets, but all of the segments compose a single curve. If the monopolist were restricted to selling in the home market, his output would be  $OA$  and monopoly price  $AP$ . Now if he desires to sell abroad, he must dump since the foreign demand curve throughout its entirety lies below  $P$ . But this he can do with advantage to himself, because, as soon as he pushes production to  $OA$  at home, his marginal costs ( $AT = O'S$ ) become lower than marginal revenue from sales in the foreign market. It will therefore pay him to expand his output until his marginal costs equal foreign marginal revenue ( $BS^1$ ). At this output, however, marginal costs ( $BS^2 = AT^1$ ) lie below home marginal revenue, so that it will now pay to increase home sales until

<sup>15</sup> More accurately, up to the point where marginal cost, marginal revenue in the home market, and marginal revenue in the foreign market are all equal. This point is elaborated in the following paragraphs.

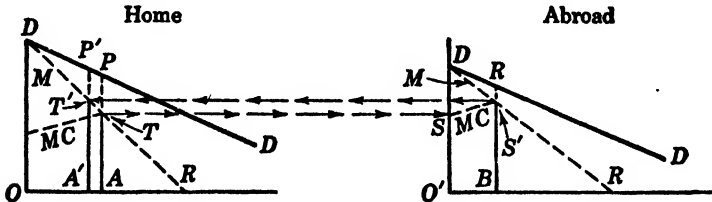
## 520 International Trade and Commercial Policy

marginal costs equal home marginal revenue ( $A^1T^2$ ), thus increasing home sales to  $OA^1$ . But the increase in output again lowers marginal costs, bringing them below foreign marginal revenue and making profitable additional foreign sales. This process of increasing output and lowering marginal costs will continue up to the point at which marginal costs, home marginal revenue, and foreign marginal revenue are all equal (at  $A^2T^4 = B^2S^5$ ). Beyond this point it will not pay to go. Total sales in equilibrium will be  $OA^2$  in the home market plus  $O'B^2$  in the foreign market, home price  $A^2P^2$ , and foreign price  $B^2R^2$ . Note that dumping has resulted in both a lowered home price and larger monopoly profits.<sup>16</sup>

It can be shown in a similar manner that when marginal costs are constant dumping will cause no change in the domestic price, and that when marginal costs are rising dumping will raise the domestic price. Dumping may be possible, and even profitable, with increasing marginal costs, as long as marginal costs are below foreign marginal revenue. As with falling marginal costs, equilibrium with rising marginal costs will be reached when marginal costs, home marginal revenue, and foreign marginal revenue are all equal. But with rising marginal costs, home price will be higher and home sales smaller than would be the case if dumping were not practiced. Also, the quantity dumped will not be large since the rising marginal costs will quickly equal marginal revenue.<sup>17</sup>

<sup>16</sup> The analysis here used is based upon Haberler's analysis. The diagram is a reproduction of one of his diagrams. See his *Theory of International Trade*, pp. 307-313. The chart appears as FIGURE 33 on page 308 of his book. Reproduced by permission of The Macmillan Company, publishers.

<sup>17</sup> The effects of dumping upon domestic price and sales when marginal costs are rising can be simply demonstrated. The accompanying diagram is an exact



replica of Figure 7, with the one exception that marginal costs are rising instead of falling. In the absence of dumping, the monopolist will produce and sell on the home market the quantity  $OA$  at the price  $AP$ . Since marginal costs

When reference is made to rising or falling marginal costs, it should be remembered that the description applies only to the relevant range of output. Misleading conclusions may be drawn if this is forgotten. When marginal costs are falling, for example, it might be concluded that the monopolist, in endeavoring to maximize his profits by continually expanding his domestic and foreign sales, would succeed in reducing his marginal costs to such a low level that he could undersell all competitors and establish a *world* monopoly. Although theoretically conceivable, such an end is not likely to result. For long before all competitors could be driven out, the monopolist's marginal costs would probably cease to decline and would begin to rise, due to rising prices for scarce factors of production and diseconomies incurred from excessively large-scale production.

*Dumping of Producers' Goods.* One form of dumping in particular has given rise to strenuous protest among producers in the home market, the dumping of producers' goods. It is obvious that the dumping of raw and semi-manufactured materials, and even machinery, severely handicaps other domestic producers who must use these goods in their competition in export markets with foreign producers who are able to buy materials at much lower prices; the purchase of dumped materials may even enable foreign producers to undersell domestic producers of the finished goods in the home market. Haberler cites the case of the dumping of iron and steel by the German steel cartel in Holland and England at prices often 50 per cent below German prices.<sup>18</sup> The use of dumped German iron and steel made the Dutch shipbuilding industry a formidable competitor of the German shipbuilding industry; English shipbuilders also profited. The dumping of sugar by Continental producers before the Brussels Sugar Convention of 1902 was largely responsible for the phenomenal development of the English jam and other sugar-using industries.

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at that output ( $AT$ ) are below foreign marginal revenue, it will be profitable to dump the quantity  $O'B$ . But the increased production raises marginal costs to  $BS'$  ( $= A'T'$ ), and in the face of the higher marginal costs the monopolist is compelled to restrict his domestic sales to  $OA'$  and raise the domestic price to  $A'P'$ . At this point equilibrium is attained, with marginal costs, home marginal revenue, and foreign marginal revenue all equal to one another.

<sup>18</sup> *Op. cit.*, p. 315.

## 522 International Trade and Commercial Policy

Two methods have been employed to prevent injury to domestic producers of finished goods from the dumping of raw materials by domestic monopolies. One is to reduce the home monopoly price on materials to be worked up and exported in more finished form to the level of the dumping price; the other is to preserve the home market for the domestic finishing industries by the imposition of an equalizing duty. The reduction of the home monopoly price is no more than equitable to the domestic manufacturing industries and is to be welcomed. It merely places domestic manufacturers of finished goods on a par with foreign producers so far as the cost of materials is concerned. An equalizing duty is a less effective protection against the dumping of raw materials abroad. While it does, to be sure, offset in the *home* market the undue advantage which foreign producers may derive from being able to obtain dumped materials, it does not offset this advantage in *export* markets; if no other assistance is provided domestic producers of finished goods, they may simply be unable to meet the competition of foreign producers in export markets.

### CONSEQUENCES OF DUMPING TO THE IMPORTING COUNTRY

Most of the outcry against dumping arises in the country importing the allegedly dumped goods, although a large number of the protests against dumping turn out not to involve dumping at all.<sup>19</sup> But even when the imported goods do sell at prices below those prevailing in the country of export, no injury is done the importing country by accepting the cheap imports, *provided the dumping is continuous and of long duration*. Cheapness of imports is the only valid reason for trade, and the source of the cheapness is immaterial. Consumers benefit from cheapness which results from dumping in the same way and to the same extent that they do from cheapness based on superior natural resources, more efficient management and organization, cheaper labor, or any other advantage. And it is of no consequence whether the dumping is due to monopoly abroad or to

<sup>19</sup> Inquiries into 146 complaints about foreign dumping by the United States Tariff Commission in 1919 revealed that 97 cases out of the 146 involved simply acute competition from foreign producers. Only 23 related to foreign sales below the home price. *Ibid.*, p. 297

government export bounties. The sole criterion of the desirability of dumped imports is whether the dumping can be expected to continue.

Predatory dumping is obviously harmful if it makes it possible for the dumper to drive competitors from the market and later establish a monopoly price; for the present gain from low prices will probably later be more than counterbalanced by higher monopoly prices. But to push predatory dumping to a successful conclusion is not easy. For one thing, the dumper must be sure that he can achieve a monopoly of the foreign market; and it is much more difficult to establish a monopoly of a foreign market than it is of the domestic market. While a competitor may be temporarily driven from a given export market by low prices, driving him from that market need not put him out of business if he operates from a third country behind a tariff wall and if his home market is sufficient to sustain him. For then, as soon as the dumper raises his price in the given export market, the competitor from the third country can reenter that market. Moreover, sufficiently high prices are very likely to encourage competition from new sources. Predatory dumping can be worth while only for a producer who has in prospect a monopoly in the entire world outside the country into which he dumps. But if he has, or is a member of, such a potential world monopoly, it will usually be easier, and more profitable, to bribe or threaten recalcitrants into joining the combine than to dump. Again, it takes time to realize the fruits of predatory dumping, and, before the fruits have ripened, the would-be monopolist may find that governmental intervention either subjects him to the payment of special anti-dumping duties or excludes him entirely from the coveted market.

Sporadic dumping, while it may prove an infernal nuisance to producers in the importing country, is probably not very harmful. It occurs infrequently and does not persist long enough at any one time to force any shifts in production. Dumping is really injurious only when it occurs intermittently and yet lasts long enough to cause shifts in production which must be reversed when the dumping ceases. Intermittent (short-run) dumping may prove to be a source of serious disturbance even if there is no competing industry in the importing country. If the dumped goods are raw materials, new industries may be promoted which cannot survive when the low-

## 524 International Trade and Commercial Policy

priced materials are no longer available. And, even though no new industries are given birth, the temporary cheapening of various imports may lead to diversions of spending which cause serious industrial disturbances when they are later reversed.

To permanent dumping, no valid objections of an economic nature can be raised, although from the political standpoint it may be desirable to combat the dumping of any products which menace domestic industries considered essential to the national defense. It is only when dumping renders goods *temporarily* cheap that it becomes basically objectionable; this is especially true of predatory dumping, which undertakes to destroy competitors and later raise the price. It should be added, however, that temporary cheapness due to dumping is no more harmful than temporary cheapness due to any other cause. There is perhaps a presumption against dumping in that, to use the words of Professor Haberler, "the probability that the cheap imports will continue is less when they are dumped than when they are cheap for other reasons."<sup>20</sup>

### MEASURES TO COMBAT DUMPING

Four different means of preventing the entry of dumped goods into a country have at one time or another been suggested: ordinary protective duties, special anti-dumping duties, the prohibition of the importation of dumped goods, and permission to reimport duty-free into the country of origin any goods dumped from that country. Any one of the first three measures can be taken independently by the importing country; the fourth requires the cooperation of the government of the dumper's country.

Ordinary, permanent protective duties are not an effective means of excluding dumped goods unless they are strictly prohibitive. As long as a certain quantity of a particular article can come in over a tariff wall, lowering its export price will obviously cause more of the good to enter. Only when the tariff is prohibitive, in the sense that it exceeds the maximum possible difference between the foreign home market price and the foreign export price, will ordinary protective duties discourage dumping.<sup>21</sup> It is doubtful if a free trade

<sup>20</sup> From Gottfried von Haberler, *The Theory of International Trade*, p. 322. By permission of The Macmillan Company, publishers.

<sup>21</sup> Making allowance, of course, for transport costs.

country is in any way more exposed to dumping than a protectionist country. Some of the most highly protectionist countries in the world, e.g., Canada, Australia, South Africa, and the United States, have considered it necessary to add to their regular tariffs special duties against dumping. A free trade country may even be less subject to sporadic dumping than a protectionist country, as the former is likely to be a better export market for the dumper than the latter and the dumper may be fearful of disturbing the price structure in the better market by lowering prices there in order to dispose of a casual overstock. Regular protective duties may actually foster dumping if in the absence of duties goods could be sold in a given market without dumping while after the imposition of duties they have to be dumped to get over the tariff wall. Permanent duties will, of course, prevent dumping if dumping was practiced before the erection of the tariff and if in order to get over the tariff wall further price reductions would have to be greater than the dumper is willing to make. But the strongest argument against the use of permanent tariffs to combat dumping is, as has been argued at length in earlier chapters, that they cause an uneconomic reallocation of productive resources and interfere with the international division of labor. They also tend to encourage dumping from the protectionist country, for the protection of a tariff wall facilitates the creation of a domestic monopoly.

Special anti-dumping duties can be set high enough to bar dumped goods, and they are not open to theoretical objection so long as they are limited to real (more strictly, intermittent) dumping, their application is restricted to the duration of the dumping, and they are not permitted to develop into general protection. In practice, however, the danger is great that pressure will be exerted to invoke them whenever domestic producers find foreign competition in the home market becoming uncomfortably rigorous, and that, once invoked, vested interests will succeed in preventing their withdrawal. For this reason, Professor Viner, in justifying the use of special anti-dumping duties, confines his approval of their use to free trade countries.

Complete prohibition of imports which are judged to be dumped is obviously a most effective device for curbing the practice, but the very effectiveness of the measure makes it particularly subject to



## 526 International Trade and Commercial Policy

abuse at home and a source of resentment abroad. Allowing the reimportation duty free into the country of origin of dumped exports limits the dumper's price differential between domestic and export sales to the sum of the outward and inward freight charges, but export prices may still be reduced below domestic prices by any amount less than this. As protection to the importing country, this would require an international agreement and would be sure to arouse organized resistance by powerful interests in the exporting country.<sup>22</sup>

Serious question has arisen concerning the compatibility of anti-dumping duties with most-favored-nation obligations, particularly when such duties are made applicable to *all* shipments originating in a given country instead of to specific shipments.

### ANTI-DUMPING LAWS

Canada in 1904 enacted the first anti-dumping law which specifically provided for the imposition of additional duties on imports sold at dumping prices. Since that date, Canada's example has been followed by the Union of South Africa, the United States, Great Britain, Australia, New Zealand, Newfoundland, Japan, Germany, and Rumania. The Canadian, United States, and Newfoundland laws are mandatory in form; the others are applicable at the discretion of the customs or other authorities. Some of these countries have laws which do not refer specifically to dumping, but which authorize an increase of duties by administrative act whenever a domestic industry is threatened by "abnormal or unreasonable foreign competition." Where the anti-dumping laws have been systematically applied, there seems to be fairly general agreement among customs officials and business interests, according to Viner,<sup>23</sup> that this legislation has been successful in checking serious and systematic (long-run) dumping. In those countries where the anti-dumping laws have been largely inoperative, one of the chief reasons for their failure appears to have been that the countries have depended in their ordinary tariffs largely upon specific duties and so have had

<sup>22</sup> Some countries have attempted to protect themselves from bounty dumping by introducing into commercial treaties provisions pledging the signatory governments not to grant bounties. Such pledges have, however, frequently been violated.

<sup>23</sup> *Encyclopedia of the Social Sciences*, Vol. V, p. 277.

no administrative machinery for ascertaining the values of imports, an indispensable condition for the effective use of anti-dumping legislation.<sup>24</sup>

An appraisal of anti-dumping legislation raises many questions. While the systematic application of existing laws may have successfully checked long-run dumping, it is to be remembered that it is just this type of dumping which is not injurious. Sporadic dumping is usually of such brief duration that before the penalties can be put into effect the dumping has ceased. The difficulties and dangers encountered in the use of anti-dumping duties to curb intermittent dumping, the truly injurious type, have been ably explained by Beveridge.<sup>25</sup> First, there is the difficulty of time. If previous notice has to be given of the duties, as is common, dumped goods may be rushed in before the duties go into effect, and sporadic dumping will probably have terminated before the duties can be imposed. If no notice is given, a disturbing degree of uncertainty is injected into the operations of importers, for it is practically impossible to learn beforehand whether a particular transaction will be treated as dumping. Second, it is by no means easy to ascertain what prices actually are, especially domestic prices in the foreign market. Where there is more than one producer and prices of different producers are not identical, whose price is to be taken? Prices published in trade journals, again, are frequently misleading because actual sales are made at prices lower than the quoted ones. Most difficult of all, perhaps, is the reduction of all the relevant conditions of sale—

<sup>24</sup> The penalties applied under these laws fall into three general classes: additional duties equivalent to the difference between the foreign market value and the export price, a flat rate of duty (in Great Britain a duty of 33½ per cent is provided for), and prohibition of import. Usually a margin of tolerance between the foreign market price and the home price is allowed before the penalties are invoked; this is generally 5 per cent, but it sometimes runs as high as 10 per cent. This would appear wise in view of the difficulty of determining prices in foreign markets, and at the same time it makes allowance for shrewd bargaining by the importer. Public notice of from six weeks to three months is ordinarily required before the special duties go into effect. The mere threat of additional duties may be sufficient in some cases to cause dumping to cease. A comprehensive analysis of earlier dumping laws is to be found in Viner, *Dumping: A Problem of International Trade*, Ch. XIV; a more recent analysis has been made by the Federal Trade Commission in *Antidumping Legislation and Other Import Regulations in the United States and Foreign Countries* (1934).

<sup>25</sup> *Tariffs: The Case Examined*, p. 129.

## 528 International Trade and Commercial Policy

quality, quantity, credit terms, packaging, point of delivery, etc.—to domestic and to foreign purchasers to a comparable basis. The determination of what are strictly comparable prices in two widely different countries has usually to be solved in practice by placing in the hands of customs officials a large amount of arbitrary power. Third, anti-dumping duties, like all other duties, have a tendency to become permanent. The South African laws, for example, contain no provision whereby anti-dumping regulations enforced against a particular trade cease to operate after a fixed term unless specifically renewed; only positive action by the authorities can force a return to the *status quo ante*. And be sure that the interested trades will not urge such a return! Finally, there is a tendency in the administration of anti-dumping laws for the interests of the general public in low and competitive prices to become subordinated to the special interests of a small group of producers desirous of discouraging keen competition.

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## *International Combinations*

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Competition was the economic watchword of the nineteenth century. Both the economist and the political scientist regarded free competition as the spur to efficiency, the enemy of incompetence, the guardian of the consumer, and the indispensable condition of maximum social and individual wealth and welfare. The nineteenth century, moreover, gave promise of the attainment of an economic system guided by the enlightened hand of free competition, as the numerous monopolies and regulations imposed by governments of the early modern period were gradually broken down and disappeared. The passing of the East India Companies threw open the gateway to trade with Asia; the end of the colonial status in America opened the door to the New World on equal terms to all comers. A wider range was granted to free enterprise by the abolition of guild privileges, the repeal of apprenticeship laws, the end of serfdom, the scaling-down of tariffs, and improvements in transportation. Granted this greater freedom, competition might dominate economic life.

Competition is a means, however, not an end. The end of business activity is profit. Although competition may be the invisible hand which safeguards the interests of consumers, at the same time it frequently jeopardizes profits. New industries, new firms, new methods, and new commodities may vanquish the old; but, when the victory has been won, the victors may discover that they have become so numerous that competition among them becomes cut-throat,<sup>1</sup> or the increase in productive capacity which characterizes every boom or war may leave many industries overexpanded when

<sup>1</sup> By forcing prices below the average costs of each and every producer for considerable periods of time.

## 530 International Trade and Commercial Policy

depression or peace comes. Some producers and sellers may be able to escape the most extreme rigors of competition through the ownership of popular trade-marks, the undeviating loyalty of customers, the possession of a patent, a natural monopoly, the tenancy of a geographical location which virtually frees them from the fear of rivals, or such outstanding success as a competitor that they are able to knock off all rivals and establish a monopoly. Furthermore, where the number of competitors is small, each one is likely to take a keen interest in the price and productive policies of each of the others. If each producer or merchant adjusts his own prices and volume of output to the policies of the others, the result will closely approximate that which would be achieved under pure monopoly.

While the protection of monopolistic ingredients tempers the rigors of competition for some producers, for many others there is no such relief. To the latter, competition does not appear to be the life of trade or the law of progress; it is, rather, the road to ruin, to be avoided if possible. Cooperation, instead, becomes not only the life of trade, but the very law of self-preservation. Business agreements and combinations have thus evolved primarily for the purpose of limiting, and even eliminating, competition so that profits may be assured and later increased. Industrial combinations, which had developed originally to control competition within individual nations, tended to become international in scope as soon as they ran afoul of competition from abroad. Liefman estimates the number of international cartels at the beginning of the twentieth century at 40, Harms estimates it for 1912 at 100, and Wägenfuhr estimates it at 320 during the 1920's.<sup>2</sup> A tentative list of international cartel agreements in effect in 1939, prepared by the United States Department of Justice, places the number at 179, of which 109 included in their membership American enterprises.<sup>3</sup>

### TYPES OF INTERNATIONAL COMBINATIONS

Descriptions of the combination movement have suffered from the lack of a standard terminology. Terms are used loosely, and the meaning of the same term frequently varies from country to coun-

<sup>2</sup> Haberler, *The Theory of International Trade*, p. 329.

<sup>3</sup> Corwin D. Edwards. "International Cartels as Obstacles to International Trade," *American Economic Review*, Supplement, March 1944, p. 330.

try. In the United States the term "cartel" was up to a short time ago seldom used; in Germany, on the other hand, nearly all combinations were described as "cartels" until recently, when new terms with special meanings have appeared. The terms "pool" and "cartel," as commonly used in the United States and Germany respectively, mean pretty much the same thing, although the pool in the United States has usually been less formally organized than the cartel in Germany. Recently, a tendency has become evident in countries outside Germany to characterize all types of combinations as "cartels," particularly those which cut across national boundaries.

An international combination is an arrangement among business enterprises engaged in the same type of industry to avoid some, or all, forms of competition, the parties to which are domiciled under more than one government and trade across national boundaries. Some international combinations include the major enterprises which operate in a given field throughout the world, others restrict their operations to a regional scale. Combinations restricted to a regional basis are possible if the areas which they do not dominate do not export the cartelized goods, or if the area included in the agreement is protected against outside competition by governmental or natural barriers to trade. Sometimes, enterprises which sell throughout the world enter cartel arrangements which control members' activities within regions where their interests can be reconciled, but sanction competition among members of the cartel in other regions.

The particular forms of organization employed to consummate industrial combinations among firms in different countries do not differ from those utilized to combine enterprises within a single country. Although there are many differences in the details of organization, international combinations may be classified into three broad types: the cartel, or association, the patent-licensing agreement, and the combine.<sup>4</sup>

1. *The Cartel.* The international cartel is an association of independent producing companies in various countries, created for

<sup>4</sup>This is the classification used by Corwin D. Edwards in *Economic and Political Aspects of Cartels*, Senate Committee Print, Monograph No. 1, 78th Congress, 2nd Session. I have drawn generously upon Professor Edwards' monograph for the material in this chapter.

## 532 International Trade and Commercial Policy

the purpose of influencing the conditions of sale in the interests of its constituent members. Cartels may formally agree to fix prices, to limit and apportion output, sales, or exports, to redistribute profits according to a predetermined formula, to allocate market territories, or even to sell through an incorporated sales organization, which takes over all the goods produced and remits a return in accordance with the organization's policy. With the exception of the particular objects involved in the cartel agreement, the cartel does not interfere with the independence of its members. Complete autonomy is retained by its members in respect to all other matters, such as production, finance, administration, and labor policy. The economic power of a cartel obviously depends upon the proportion of the total output which it controls and the willingness of its members to conform to the terms of the agreement. Members may break their cartel contracts and indulge in chiseling with impunity, however, in those countries where cartel agreements are unenforceable at law, or where participation in them is even subject to legal penalties, as, for instance, in the United States. Consequently, the cartel is an especially vulnerable kind of combination. Since American enterprises have been prevented under the antitrust laws from making price agreements, those cartels which have included American enterprises have usually endeavored to operate under the cloak of the patent laws in the hope that their cooperative efforts would thus become legal. In certain cases, they have experimented with various forms of joint ownership.

Prior to World War I, international cartels existed in industries dominated by a few large firms, including shipping, armaments, steel rails, electric bulbs, aluminum, calcium carbide, plate glass, enamelware, and bottles. Some of these cartels disintegrated during the war; but, when peace came, they were soon rebuilt and many new ones were created, affecting potash, oil, steel, rayon, dyestuffs, nitrates, copper, zinc, tin, mercury, nickel, glue, paper, wood pulp, linoleum, quebracho, diamonds, and rubber. A brief description of two leading international cartels may help to understand their organization and activities.

Since the early 1930's, natural rubber has been controlled by a governmental restriction plan known as the International Rubber Regulating Committee. This cartel includes the United Kingdom, In-

dia, Thailand, France, and the Netherlands. The cartel was created primarily for the purpose of reviving rubber prices, which had fallen sharply upon the outbreak of the depression, and from its inception down to the fall of Singapore in early 1942 it maintained one of the strictest monopolies in existence. The world's rubber-producing territory was divided into nine zones, and a production quota, based on past exports, was established for each. The percentage of these quotas which the countries may export is fixed from time to time by the IRRC. New planting, except for experimental purposes, is prohibited, but research is encouraged. Within a few months after the completion of the agreement, the Committee had restricted exports to 70 per cent of the base quotas. The Committee has complete power to impose whatever degree of restriction upon exports it sees fit in order to reduce existing world stocks to a satisfactory figure and to maintain "a fair and equitable price-level which will be reasonably remunerative to efficient producers." The interpretation of "a fair and equitable price-level" rests with the Committee. As a result of this restrictive program, world stocks were cut in half and prices had more than doubled within two years. Even with the outbreak of war in 1939, quotas were not materially relaxed.

Although cartelization in the steel industry has a history running back to the beginning of the century, or farther, the first International Steel Cartel did not come into being until 1926. Plant capacity double the domestic and export demand made European producers eager to collaborate with the German initiators in a restriction plan which would solve their over-production worries and permit them to profit from a higher world price. The raw-steel makers of Belgium, France, Germany, Luxembourg, and the Saar were the original members of the Cartel, and were joined in 1927 by the producers of Austria, Hungary, Czechoslovakia, and Rumania. The Cartel assigned to each member country an indirect monthly quota, an absolute production limit beyond which individual concerns could produce only at a penalty. Each member firm was required to contribute to a common fund a production tax of \$1 a ton, a part of which was later refunded. Any firm violating its quota had to pay a penalty of \$4 on each excess ton of steel produced. By the time the depression had forced a dissolution of the first International Steel Cartel, Germany had paid \$12,000,000 in excess production



## 534 International Trade and Commercial Policy

finances, most of which was refunded to France, whose production had fallen short of her quota. The Cartel was renewed in 1933 by its original members. This second agreement was related exclusively to the export market, and disregarded the volume of output and domestic marketing conditions. It established a quota system for particular steel commodities and regulated prices of these commodities directly through export syndicates; it extended its structure to the organization of distribution, and went so far as to promote cartels of merchants in importing countries.<sup>5</sup> War brought a dissolution of the second International Steel Cartel.

2. *The Patent-Licensing Agreement.* The most common type of international combination among large manufacturing enterprises, especially in those industries in which technological advance is rapid, is the patents and processes agreement. Participation in such agreements rests upon either the ownership of patents or the license to operate under patents. Since patent ownership in most countries carries certain monopolistic rights, and since in many countries these rights have been ill defined, it has frequently been possible to establish industrial combinations in the form of patent-licensing agreements even in countries in which other forms of combinations are legally banned. The agreements may be developed instance by instance, as each patent is issued and licensed, or the allocation of a series of patents may be determined in advance.

The patents agreement is a market-sharing arrangement according to which each member recognizes certain territories, and perhaps certain industrial fields, as the private domain of the other. The achievements in the research of each member are patented in every country covered by the agreement, and the right to use the patents is conveyed to the other member of the agreement by assignment of the patents or by licenses under the patents. Within the private domain of each party, patent grants exclude the activities of third parties, and often even those of the company to whom the patent was originally issued. In certain areas and industrial fields not assigned exclusively to either party, the parties to the agreement may compete with each other, or either of them may compete with outside companies to which similar non-exclusive rights have been granted. In addition to the allocation of territories and industrial

<sup>5</sup> See Ervin Hexner, *The International Steel Cartel* (1943).

fields, patent-licensing agreements may control selling prices, output, the types of concerns through which distribution may be made, and various other aspects of their business activities. An arrangement between two leading companies for the allocation of exclusive industrial fields and territories not only prevents competition between the parties within the field and territory covered by the agreement, but also deprives outsiders of the chance to compete within these fields so far as the patents, processes, and "know-how"<sup>6</sup> of the parties is needed for such competition.

The significance of patent-license controls within a given industry cannot be ascertained by merely examining individual patent licenses, but only by surveying the entire patterns of these controls. When it is necessary for two large concerns to come to terms with other concerns which may be powerful in some limited portion of a broad field of industry, supplementary agreements may be made which include the additional concerns and divide up the special markets not just between the two concerns, but among three, four, or more. The actual organization of the combinations that are based upon the control of patents is achieved by means of (1) a few broad agreements between pairs of major firms, each agreement covering virtually the entire field in which the interests of the two concerns overlap, (2) a larger number of agreements affecting particular types of product, which govern the relations of most of the producers making that product, and (3) many agreements of lesser scope designed to deal with lesser problems. For example, Dr. Edwards points out<sup>7</sup> that in the chemical industry before World War II

. . . there were comprehensive patents and processes agreements between du Pont and Imperial Chemical Industries (of Great Britain) and between I. G. Farbenindustrie (of Germany) and Standard Oil Company of New Jersey. There was a gentlemen's agreement between du Pont and I. G. Farbenindustrie by which each was to give the other first option on new processes and products not already promised to third parties. There was apparently a comprehensive working arrangement as to specific products between Imperial Chemical Industries and I. G. Farbenindustrie. Around this central pattern were grouped various lesser alliances among other companies, and many special agreements among manufacturers of

<sup>6</sup> Secret processes and unpatentable industrial experience.

<sup>7</sup> *Economic and Political Aspects of Cartels*, p. 6.

## 536 International Trade and Commercial Policy

dyestuffs, plastics, explosives, pharmaceuticals and other chemical products. The chinks of the structure were filled by numerous small patent-license contracts which contained restrictive features.

Although the life of a patent is by law limited to a specified number of years, cartel arrangements based on patents may endure far beyond the statutory limits of the patent grant. When the basic patents are about to run out, improvements upon the basic processes may be patented and the agreements may be extended upon the basis of these patented improvements, for the leading companies in industries that employ technological research are not likely to lack patentable inventions. Even when patent agreements come to an end, their effects are apt to persist for some time thereafter because a company which has once withdrawn from another's territory and industrial fields does not easily reestablish itself against the determined opposition of the firm which has held a monopoly of these portions of the market. Furthermore, when competition is eliminated in the particular fields covered by the patents, it usually disappears between the same companies in the reserved territories with respect to unpatented products. It is impractical, in industries which depend upon research, to market old products without improvements in the territory of the grantee or to maintain there a sales organization which is limited to the sale of the unpatented products.

3. *The Combine.* The combine is a stronger and more closely knit form of international combination than either the cartel or the patent-licensing agreement. Whereas the latter two types of combination preserve the independence of the constituent firms, except as regards production, sales, or export quotas or price controls, the combine unites competitors under a common ownership or management, with unified financial control and centralized authority over production technique, labor and commercial policies, and other matters. Various devices have been utilized to attain such unified control, such as the exchange of shares among the constituent members, the trust, the holding company, outright merger, jointly owned subsidiaries, and certain informal and indirect arrangements.

An outstanding example of a world-wide combine is the rayon industry. Through a vast and intricate network of interlacing interests, both financial and industrial, constructed mainly by means of

various exchanges of shares and agreements for the interchange and pooling of technical knowledge, the three largest rayon producers in the world—Courtauld's, Ltd., of Great Britain, Vereingte Glanzstoff Fabriken of Germany, and Snia Viscosa of Italy—were brought into a tightly welded combination, along with the leading manufacturers in France, the Netherlands, and other countries. One or another of the members of the combine also controlled the bulk of rayon manufacture in the United States.<sup>8</sup>

The International Telephone and Telegraph Company is a vast holding company which holds all or most of the stock of a variety of cable, radio communication, and telephone companies throughout the world. It also owns the stock of International Standard Electric Corporation, which in turn is a holding company controlling companies all over the world that manufacture communications equipment. The Continental Linoleum Union, a Swiss corporation, through ownership of shares in German, Swiss, Swedish, Lithuanian, and Norwegian companies and agreements with manufacturers in the Netherlands, France, and Great Britain exerted prior to the war a strong monopoly influence over the prices of its products. The vast Unilever interests, producers of soap, glycerine, margarine, candles, dairy products, vegetable oils, and many other articles and owners of many retail outlets, are controlled by two great holding companies—Unilever, Ltd., of Great Britain and Unilever N. V. of Holland. Joint British and Dutch control over these two holding companies is effected through a 50 per cent stock ownership in each of two private companies, one British and one Dutch.

A large number of companies which manufacture and distribute radio equipment, electric light bulbs, and other electrical supplies in many different countries are organized under the name of N. V. Philips. Prior to the recent war, common ownership of these widely-scattered companies was exercised by a Philips company in Holland, which in turn was controlled by a company with only 10 effec-

<sup>8</sup> Alfred Plummer, *International Combines in Modern Industry*, 2nd ed. (1938), pp. 35-38.

In 1938 Courtauld's and Imperial Chemical Industries made a patent agreement with du Pont with respect to nylon yarn. The understanding was that Courtauld's was to join ICI in forming a company to manufacture nylon yarn. These patent rights extended only to the British Empire exclusive of Canada. Ervin Hexner, *International Cartels*, p. 382.

## 538 International Trade and Commercial Policy

tive voting shares. During the second World War, control was organized into two groups, one presumably for the countries under Axis control and one for the others. The control of the Philips companies which were beyond Axis domination was vested largely in two groups of trustees, one in Hartford, Connecticut, and the other in London. The trust agreement provided for the reestablishment of the pre-war pattern when the war should be over.<sup>9</sup>

Imperial Chemical Industries and du Pont successfully brought under control in Canada competition between themselves in those chemical fields occupied by both companies by setting up a jointly owned subsidiary, Canadian Industries, Ltd., which is the exclusive manufacturer and importer of these products for both companies in Canada. A subsidiary of I. G. Farbenindustrie and du Pont together own the Bayer-Semesan Company, through which both corporations carry on in the United States all their business pertaining to seed disinfectants. In Brazil and in Argentina, du Pont and Imperial Chemical Industries have organized subsidiaries under the names of "Duperial," and have agreed to do business in each country only through the Duperial company of the country. The Duperial companies not only manufacture, but also import and distribute the products of the parent companies.

Informal or indirect arrangements, such as interlocking stock ownership, interlocking directorates, and communities of interest based upon ties of blood, may be as effective devices for establishing unity in production, market, or price policies as formal stock ownership. The president of Rohm & Haas of Philadelphia was a former partner of Rohm & Haas of Darmstadt, Germany, as well as voting trustee for 30 per cent of the American company's stock owned by the head of the German company. Since 1928 the entire aluminum-producing industry of the world, with the exception of the Aluminum Company of America, has been joined in a strong cartel combining all the important producers of Austria, Canada, France, Germany, Great Britain, Italy, and Switzerland, as well as certain Norwegian producers. Although the Aluminum Company of America (Alcoa), which before the second World War held a monopoly of aluminum production in the United States, was not a member of the international cartel, Alcoa in 1928 created the

<sup>9</sup> Edwards, *op. cit.*, p. 8 and chart facing p. 70.

Aluminum Company, Ltd., (Alted) in Canada, and "sold" to its own offspring all foreign properties which it possessed, with the exception of its Dutch bauxite mines and a few minor holdings. For these properties, Alcoa received 490,875 shares of the Canadian company's stock. Instead of holding these shares of Alted in its own treasury, however, Alcoa distributed them proportionally to its principal stockholders, with the result that as late as 1940 the owners of 81.53 per cent of Alcoa's stock also owned 83.93 per cent of Alted's stock. The president of the Canadian company is a brother to the chairman of the board of Alcoa, and both are members of one of the three families which control both companies. Although Alcoa is not a member of the world aluminum cartel, Alted is. It is not strange, therefore, that European producers have not sought to invade Alcoa's domestic stronghold, even though Alcoa is not a member of the international aluminum cartel.

#### CONDITIONS CONDUCTIVE TO INTERNATIONAL COMBINATION

Combinations are most easily created and, once created, are most likely to be effective when the number of producing firms is small. Where the individual producing firms are small in size and numerous, combinations, either national or international, rarely come into existence, unless directly encouraged by government. Firms tend to be large in size and small in number in industries using mass-production methods and requiring large aggregates of capital so that entry into the field necessitates a heavy initial investment.

Where the firms in a given industry are already combined in the different nations, consolidation on an international scale is tremendously facilitated, for it is easier to secure an agreement among a very few members who have already manifested their faith in combination than among a larger number of independent units, and there is greater certainty that the agreement once made will be respected. Some authorities go so far as to maintain that previous monopolistic organization on a national scale is an indispensable condition of international combination. This view is clearly expressed by Sir Alfred Mond, organizer of Imperial Chemical Industries:

## 540 International Trade and Commercial Policy

. . . You cannot discuss big problems of industry with other countries until your own industries are organized first. Only recently I had occasion to talk with the leaders of big organized industries on the Continent, in Germany and in America, and I discussed this subject. These people want to talk to one or two men who represent industry in England, and if I heard one complaint made it was the impossibility of carrying on any negotiations with some great English industries, because they have not yet solved this problem and there is nobody to talk to. There is simply nobody with authority, and however big any individual company may be, it represents only a small fraction of the industries of the nation, and therefore a representative of it cannot speak in an authoritative manner.<sup>10</sup>

National monopolistic organization is easiest to attain, in turn, where tariffs and high transport costs have impeded external competition.

One of the most fertile fields for the growth of international cartels has been those industries in which the process of manufacture or the fabricated product can be patented, so that a monopoly may be established which is not easily invaded.<sup>11</sup> Still another condition which has favored the organization of international cartels has been the natural scarcity of a basic raw material, particularly where the sources of supply have been limited and have been concentrated in a small number of regions. These conditions have been prominent in the cartels in rubber, tin, quebracho, mercury, diamonds, potash, quinine, and petroleum. Lastly, government cooperation or leadership may be the dominant factor in the organization of an international cartel. In the creation and maintenance of the Franco-German potash cartel, the international tin cartel, and many others, government support has played a significant role.

*Raw Material Controls.* The fact that the sources of supply of a raw material lie wholly within the territory of a single nation does not by itself make possible the monopolistic exploitation of consumers, either at home or abroad. Such monopolistic exploitation

<sup>10</sup> Quoted in *ibid.*, p. 2.

<sup>11</sup> Of the 179 international cartel agreements which made up the list of the Department of Justice in 1939, 133 covered manufactured and semi-manufactured goods, 32 covered minerals, 8 agricultural products, and 6 various services. The preponderant proportion of fabricated products reflects the importance of patents and large-scale production as conditions favoring international combination.

demands in addition that producers be organized in such a way that production and supply may be controlled and restricted. The production of agricultural raw materials, for example, usually involves a large number of producers; the intervention of the government is therefore necessary in order to secure adequate organization and regulation for the successful control of such raw materials. Of 20 cases of raw material control listed by Wallace and Edminster,<sup>12</sup> all but two involved some degree of government participation or support. Government support for raw material restriction schemes has sought to achieve one or more of four objectives: (1) to obtain public revenue, usually through export taxes or government monopoly; (2) to stabilize or increase prices in order to maintain or increase the profits of the producers; (3) to foster and extend domestic manufacturing industries which use the raw material by enabling them to secure it at a lower price than their foreign competitors have to pay; (4) to conserve natural resources by preventing too rapid a rate of production.

Government intervention to establish a measure of control over a particular commodity and to raise its export price may assume one of several forms. A state monopoly of production and trade may be created, as in the case of the Japanese camphor monopoly. A private monopoly may be organized with which producers are compelled by the state to combine; an example of this situation is the nitrate syndicate in Chile. Quotas or duties upon exports may be imposed. Chile has long laid a tax upon exports of nitrates, while many cartels have subjected exports of the cartelized product to quotas. Production may be directly restricted, as by the International Rubber Regulating Committee and the diamond syndicate in Africa. Finally, the government may purchase surplus supplies of the commodity in order to raise and stabilize its price. The Federal Farm Board in the United States undertook such a responsibility with respect to wheat and cotton in the early 1930's, and the Brazilian government undertook to support the price of coffee by similar means beginning in 1921.<sup>13</sup>

While the various restriction schemes for raw materials have usually met with early success in securing better prices for pro-

<sup>12</sup> *International Control of Raw Materials*, pp. 13-15.

<sup>13</sup> Valorization of coffee was begun by the State of São Paulo in 1906.



## 542 International Trade and Commercial Policy

ducers, in most cases this success has been short-lived. Raw material controls have broken upon one or the other of two shoals, each the result of the higher prices wrought by the controls. Either it has proved impossible to restrict permanently the total supply, owing to the growth of production in countries outside the scheme because high profits accrue to outside producers, or technical research has been encouraged which has produced satisfactory substitutes. The Stevenson Plan, introduced in 1922 by the British government to restrict the output of crude rubber in the Malay States, succeeded within a few years in raising the price of rubber from \$0.13 to \$1.23 a pound, but it broke down shortly thereafter because the plantations in the Netherlands Indies greatly increased their production. After the sharp decline in crude rubber prices during the Great Depression, a new cartel was formed which included the Dutch, as well as producers in Thailand and French Indo-China; the new cartel has proved much more successful than the old. The extensive development of synthetic rubber production during the war, however, has made the future of crude rubber, at best, uncertain. In similar fashion, the attempts of the Brazilian government to improve the condition of Brazilian coffee producers by bolstering the price of coffee through government purchases have been frustrated by increased production in other countries, as well as in Brazil itself. Likewise, the success of American control schemes in raising the price of American cotton has enabled cotton producers in other countries to expand their output considerably, and has encouraged the development of virtually new cotton exporting industries, notably in Brazil—all at the expense of American cotton exports.

Since early in the twentieth century, the Japanese government has practically monopolized the collection and sale of raw camphor, to its own good profit. But since 1910, and particularly since the first World War, Japan's hold on the camphor market has been greatly weakened by the competition of synthetic camphor. By 1929, American imports of synthetic camphor from Germany approximately equaled those of the Japanese natural product, and the price of each kind had declined sharply. The possession of the only known workable deposits of sodium nitrate for many years gave Chile virtually a world monopoly of natural nitrate, to the enrichment of Chilean producers and the public treasury of Chile. An investigation of the

industry by the Chilean government in 1927 revealed that in the period 1920-1927 many producers had realized a return of more than 50 per cent on their capital, another large group from 25 to 50 per cent, and few less than 10 per cent. But even during these years Chilean producers were already paying the cost of monopoly. The phenomenal growth since 1920 in the fixation of atmospheric nitrogen and the recovery of nitrogen compounds as by-products of several industrial processes has completely broken the Chilean monopoly. By 1929, Chile's share of the world production of nitrogen constituted only 22 per cent, and has since fallen even below that. Participation in a cartel with European producers has done little to improve Chile's position.

At the outbreak of war in 1939, several raw material cartels still retained a dominant monopolistic control, for example, the diamond, natural rubber, quebracho, quinine, and tin cartels. War, however, brought forth atabrine to challenge quinine, and synthetic rubber to haunt producers of the natural product. Who shall say when the emergence of a substitute or the appearance of a new source of supply will rise to challenge the control of the others? The exigences of war have made consumers all the more eager to free themselves from raw materials scarcities, whether natural or man-made.

*Webb-Pomerene Export Associations.* American producers have found it inexpedient to participate in outright international price and marketing agreements because of the hostile attitude of the United States government as expressed in American antitrust laws. But they have frequently attained the same ends through patent-licensing agreements, interlocking financial and other less formal arrangements, which appear not to be explicitly covered by the antitrust laws. Under the Webb-Pomerene Act of 1918, however, American exporters are granted exemption from the antitrust laws in order to combine among themselves, or with foreign groups, for the more efficient conduct of American export trade. It was felt that with the development of cartels and combines abroad and of export monopolies of various types outside this country the antitrust laws of the United States placed unorganized American exporters at a disadvantage in foreign markets when competing or bargaining with closely organized and powerful foreign groups. When any group of exporters wishes to combine as a unit for export

## 544 International Trade and Commercial Policy

trade, it must register with the Federal Trade Commission and make annual reports to the Commission. The Act extends the jurisdiction of the Commission to unfair methods of competition used in the export trade, even though such unfair practices are perpetrated beyond the territorial jurisdiction of the United States.

If one may judge from the number of Webb-Pomerene associations, the advantages claimed for the combination form of export association are more apparent than real. In 1936 there were only 45 such associations, the total value of whose exports amounted to only \$149,396,525, or 6 per cent of our total exports. Another fact which raises doubts of the reality of the advantages alleged for export associations is the relatively short life of Webb-Pomerene associations: their average existence has been only about five years. Firms which compete intensively in the domestic market are apparently reluctant to cooperate in the export market. In addition, the individual producer probably feels that by pushing his sales directly and independently he can do better by himself than by entrusting his foreign sales to a cooperative organization which must divide its attention among the products of a number of companies.

### THE GOALS OF INTERNATIONAL COMBINATION

The chief goal of international business combinations is identical with that of domestic business combinations, namely, the elimination of competition and the maintenance of prices at levels higher than would obtain under unrestricted competition, with resulting higher and more stable profits. Prices may be controlled directly, or they may be controlled indirectly through the limitation of sales and output or through the division of markets and industrial fields. Higher prices will ordinarily mean smaller total sales and a smaller total volume of international trade. Higher prices for raw materials will raise the prices of more highly fabricated products, and thus indirectly reduce output and trade. Although a cartel may be able, by expending large sums on selling and advertising, to maintain the demand for its products at such a level that sales continue to be as large as if unrestricted competition prevailed, the larger expenditures by consumers on the cartelized products must reduce consumers' expenditures on other products.

It is sometimes claimed, however, that cartels tend to increase the

efficiency of industrial production and thus operate to the public benefit. Cartels, it is argued, may realize lower costs than can be attained by many independent producers through a variety of practices: the reduction in the number of middlemen and the burden of their charges, the elimination of wasteful cross-freights, the abandonment of high-cost plants and the concentration of production in the most efficient plants, the exchange of patents and technical information, the elimination of purely competitive advertising and overlapping selling costs, the provision of improved trade information at lower costs through the central collection of statistics, more economical purchasing, and the weeding-out of redundant patterns and varieties. It is also pointed out that market gluts caused by the uncoordinated launching of new enterprises by independent producers in different countries and the consequent over-rapid expansion of world productive capacity can be avoided where producers act in concert under international agreements.

Evidence as to the validity of these claims may be gleaned from a more detailed examination of the economic practices and policies of international cartels. But before passing to this task, it should be pointed out that in the opinion of most authorities the economies of combination, as distinct from the economies of large-scale production, are of negligible importance, even in the narrower sphere of national combinations. If this judgment is correct, it would seem highly unlikely that even larger combinations, or combinations of combinations, still more remote from the main sources of operating economies and with the additional burdens of supervising and coordinating the activities of several vast establishments that produce in widely separated geographical regions, can bring any significant lowering of the costs of an industry. The potential economies from *international* combination are particularly restricted because the cartel pattern typically consists of market arrangements which do not unify the management of the various concerns. But even if combination should result in the lowering of costs, there is no assurance that these lower costs will accrue to the benefit of consumers in the form of lower prices or superior quality. Efficiency in a monopolistic combination redounds primarily to the advantage of the monopoly and may contribute little to the advantage of the community. As an example of the failure of a monopoly to pass on to the

## 546 International Trade and Commercial Policy

public the benefits of lowered costs, Professor Edwards cites the case of aluminum.<sup>14</sup> The Aluminum Corporation of America professed to have achieved substantial operating economies in the quarter-century since the beginning of World War I, as a result of centralized management and the centralized control of research. Nevertheless, under the protection of domestic monopoly and cartel arrangements which excluded imports by foreign concerns, the price of aluminum in the United States at the beginning of 1939 was nearly a cent a pound higher than in 1911. Subsequently, under the pressure of a government antitrust suit and governmental encouragement of independent manufacture, the company found it possible to reduce prices by about 25 per cent in the face of rising wartime costs. And, despite the price reduction, Alcoa profits in 1943 were so large that the government recovered from it through renegotiation \$76 million of excess profits, on less than \$500 million of contracts.

### ECONOMIC POLICIES AND PRACTICES OF COMBINATIONS

1. *Price Control.* The antecedent to a cartel agreement is frequently a price war which drives prices down well below profitable levels. Sometimes the price war is caused by excessive stocks overhanging the market—the result of over-capacity, a world-wide depression, or a declining industry. But in other cases, it is deliberately instituted by the cartel, or interests desirous of creating a new cartel, as a means of coercing rebellious elements in the industry into accepting the terms of the cartel group, such as abandoning projected expansion or even entering the cartel.

Once the recalcitrants have been brought into line, a price is set which the cartel deems most favorable to itself. This may not be as high as the theoretical monopoly price, for rarely does a combination acquire a complete monopoly of the world market. Furthermore, even if a complete monopoly is possessed, the possibility of substitutes, the fear of encouraging new competition, or the threat of government intervention will usually induce the monopoly to temper its price policy. Where the cartel is formed because of the fear of recent changes in demand or in production

<sup>14</sup> *Economic and Political Aspects of Cartels*, p. 41.

methods, the cartel price may actually be lower than that which prevailed in the industry prior to the organization of the cartel. In any case, the new price will probably be higher than would be the case under unrestricted competition. After the signing of a cartel agreement in 1928 between General Electric and Krupp of Germany, for example, the price of tungsten carbide in the United States jumped from \$50 a pound to more than \$450 a pound. It seldom went below \$225 during the depression thirties, and as late as 1940 tungsten carbide was still selling at \$205 a pound. After an indictment had been secured under the antitrust laws, the price in April, 1942, ranged from \$27 to \$45 a pound. Atabrine, a chemical substitute for quinine, was sold to the United States government for war purposes at \$4.50 per thousand tablets by companies whose patents were to terminate six months after the termination of the war. Presumably the manufacturers were making a satisfactory profit at that price. At the same time, civilians paid the Winthrop Chemical Company, a corporation which held monopoly patent rights for the civilian market under an agreement with I. G. Farbenindustrie, the German owner, \$12 per thousand tablets.

Cartel prices ordinarily exhibit a greater degree of stability than do prices in uncartelized industries. Although cartel prices tend to lag behind other prices when prices in general are rising, they display great resistance to reductions when demand falls off and plants and men are partially idle, or when improved methods bring reductions in costs. In industries in which cartel control has been incomplete, periods of high prices have, time and again, inspired an increase of productive capacity sufficient to cause a price decline so precipitous as to break the cartel.

2. *Impairment of Quality.* It is sometimes claimed that combination does not eliminate competition, but merely regulates it and turns it into different channels. In the words of Sir Felix J. C. Pole, chairman of Associated Electrical Industries, Ltd., "Competition in quality, efficiency, and service takes the place of the crude method of price cutting."<sup>15</sup> Cartels seldom concern themselves directly with the quality of cartelized goods. The absence of competition, however, diminishes the incentives for producers to improve quality and limits the opportunities for buyers to protect themselves

<sup>15</sup> Quoted in *ibid.*, p. 1.

## 548 International Trade and Commercial Policy

against low quality. Instances are encountered in which the monopolistic producer actually lowers quality, either to get a larger volume of sales or to protect another product in which he has an interest.

The impunity with which quality may be degraded is illustrated by the case of electric light bulbs. Under international cartel agreements the American market has been reserved, according to Corwin Edwards, for the two large American manufacturers, General Electric and Westinghouse. Protected from foreign competition, the American manufacturers have attempted to reduce the life of electric bulbs. One G. E. engineer wrote in 1932 that a reduction in the life of flashlight lamps from the old basis on which one lamp was supposed to outlast three batteries to a point where the life of the lamp and the life of the battery under service conditions would be approximately equal would increase G. E.'s flashlight business 60 per cent.<sup>16</sup> To prevent competition in quality, General Electric licensees were compelled to make their lamps conform in endurance and lighting efficiency to General Electric Mazda lamps and to avoid comparative tests of quality.<sup>17</sup> By agreement with electric utility companies, G. E. has refused to sell freely certain types of lamps which reduce the consumption of electric current, and in consideration has received the aid of these companies in promoting the sale of G. E. lamps.<sup>18</sup>

Certain acute purchasers of dental supplies discovered that they could obtain the methyl methacrylate, a chemical plastic, for dentures at a price of only 85 cents a pound by buying it as a commercial molding powder, whereas the very same product cost dental laboratories and dentists \$45 a pound. When the producers discovered this "bootlegging," as they termed it, they considered the addition of some ingredient to the commercial molding powder that would make the molding powder unsuitable for dental use but would not affect its molding properties. In the same vein, the du Pont Company developed a pigment which could be used either in textile dye or in paint, but they held it off the market pending the discovery of a way to make it useless as a dye, in order to maintain the prices of dyes already on the market. If the pigment were to be

<sup>16</sup> *Ibid.*, p. 16.

<sup>17</sup> *Ibid.*, p. 17.

<sup>18</sup> *Ibid.*, p. 17.

used in paint, it would have had to sell at a much lower price than the current price of dyes. A memorandum of a conference on the subject suggested: "It is known that certain resins and solvents are irritating to the skin, often causing dermatitis. It might be possible to formulate a CPC composition which will make textile materials irritating to the skin."<sup>19</sup>

3. *Allocation of Industrial Fields and National Markets.* The most common instruments of cartel policy are the allocation of industrial fields and national markets. By the allocation of industrial fields, the control of the supplies of designated types of commodities is left entirely in the hands of one or more enterprises, and all other members of the cartel are excluded from producing the designated articles. The other member, or members, however, will usually be granted exclusive control of some other article covered by the agreement. In the agreement of 1927 between I. G. Farbenindustrie and Standard Oil Company of New Jersey, for example, I. G. Farben agreed to stay out of the oil business proper, except in Germany where it was experimenting with the extraction of oil from coal, while Standard Oil was to stay out of the chemical business insofar as that had no bearing on the oil business. Restrictions of this type are often imposed in connection with patent licenses, and may therefore be interpreted as expressions of the monopoly power enjoyed by patent holders. In certain cases in which the validity of the patent has been questionable, or in which production might have been carried on without the use of the patent, threats of patent infringement suits have been employed to invoke restrictions under the patent in order to avoid competition and enlarged supplies.

When national markets are assigned to cartel members, each participant undertakes not to sell in territory assigned exclusively to others, and frequently undertakes not to sell to customers who are likely to export to the reserved territory. Other portions of the world may be left open to all members of the cartel. Since the principal interest of American cartel members has been the enjoyment of an exclusive position in the rich domestic market of the United States, and sometimes in the Canadian market, they have ordinarily been willing to sacrifice opportunities to export or to establish plants abroad as the price of an unchallenged position at home. In 1923, to

<sup>19</sup> Quoted by *The New Republic*, March 27, 1944, Part Two, p. 429.



## 550 International Trade and Commercial Policy

illustrate, the Bayer Company of Leverkusen, Germany, entered into a contract with the Winthrop Chemical Company of New York, according to which Leverkusen agreed to discontinue selling in the United States and Canada a list of specified products, produced by each party, and Winthrop agreed to take all steps within its power to prevent the sale of the products which were produced in this country in any country except the United States and Canada. Before the recent war, German exports to Latin American markets exceeded those of the United States in many lines, and this predominance of German products was attributable primarily to territorial agreements which assigned the Latin American market to German firms. The allocation of trade territories obviously restricts exports and the investment of capital abroad; it also deprives consumers of imported commodities, and domestic prices consequently become higher.

4. *Restriction of Supply.* Another very common device employed by cartels to control prices is the restriction of the available supply. Frequently, absolute limits are set upon the amount which may be produced, sold, or exported. Holders of patents sometimes enforce limitations of supply by permitting licensees to produce only restricted amounts.

Effective limitation of the supply may, however, compel the restriction of new industrial capacity. Cartels endeavor to prevent the construction of new plant when existing plant is partly idle and additional capacity will mean either larger total production and declining prices or further reduction in the output of established plants. The replacement of obsolescent plants by up-to-date ones is sometimes combated by cartels. Occasionally, they try to retard the development of new products which threaten to reduce the market for older products. Again, the primary concern may be to prevent the establishment of new enterprises which, it is suspected, would be unwilling to collaborate in cartel policies.

An amazing case of the restriction of productive capacity by means of cartel pressure is that of magnesium in the United States. Through a series of agreements between the Aluminum Company of America, the Dow Chemical Company, and I. G. Farbenindustrie, the Aluminum Company's magnesium plant in the United States was closed, thereby giving Dow a domestic monopoly. By means of a

formidable array of patents, new competitors were excluded. Dow's annual output was limited by agreement to 4,000 tons, but magnesium prices were maintained at such a high level that even this low maximum output could not be attained. Any excess production by Dow over domestic demand (at the controlled price) was bought by I. G. Farben. In this way Dow's monopoly of the domestic magnesium market was established, the substitution of magnesium for aluminum was effectively impeded in the United States, I. G. Farben's magnesium monopoly of the rest of the world was assured, and the United States' annual production of a metal which was later to prove an indispensable war material was kept at not more than one-fifth of Germany's.<sup>20</sup>

The effective control of supply demands also a rigid control of research and technological improvements. Much has been made of the gains which may accrue to the public from the exchange of patents among cartel members and from the elaborate research which combination makes possible. If the pooling of patents and "know-how" among cartel members were general, the situation, at least within the cartel, would approach that in which all new inventions were dedicated to the public use. Unfortunately, exchanges of technical information within cartels are often strictly limited. As Sir Alfred Mond explained in 1927:

The cartel or combination which exists only for a limited number of years is in reality nothing more than an armistice in industrial warfare, and people are not going to hand over arms and methods of warfare to those who in a few years may be fighting them again. Therefore, you do not get a complete and full exchange of information, of patents, inventions, and new processes. Such an exchange is of fundamental importance to progress, not merely in particular concerns but for the development of industry as a whole. . . . The way in which that can be done is by complete fusion.<sup>21</sup>

The exchange of technical information is usually contingent upon territorial limitations. Otherwise, Firm A may discover that the technical information which it has furnished Firm B only makes it possible for the latter to compete all the more effectively against it.

<sup>20</sup> An excellent account of the magnesium episode is presented by Joseph Borkin and Charles A. Welsh in *Germany's Master Plan*, Ch. XVI.

<sup>21</sup> Quoted by Edwards, *Economic and Political Aspects of Cartels*, p. 33.

## 552 International Trade and Commercial Policy

Large international concerns spend substantial sums on research, and these expenditures without question expedite technological and scientific development. Many of the inventions which result from research within a patent-controlled field, however, are not intended for industrial exploitation, but consist of minor modifications of basic patents designed to extend the period or field of the patent monopoly and to discourage competitors from entering the field. It was the practice, for example, for the German chemical industry to take out British patents on every possible chemical combination which human ingenuity could think of, even though the German cartels had not experimented with these formulae themselves and the formulae were not in operation anywhere. The patents were put in obscure and vague terms so as to cover any possible invention which might be made afterward in Great Britain.<sup>22</sup> The introduction of new processes and new products is often held up for years in order to protect established investment from obsolescence. Since the danger is ever present that new methods may be introduced by enterprises outside the cartel to the injury of cartel members, it behooves the cartel to guard against any such hazard by carefully fencing in the industrial field by means of patents. Even though the patents of the cartel members may be weaker than those of the independent, the threat of a patent infringement suit by the financially powerful cartel, or combine, will usually be sufficient to bring the independent, and financially weak, concern to terms. Dominant companies in a cartel sometimes discourage research by other member companies. General Electric apparently sought such a goal by making its lamp licensees turn over to G. E. all new inventions on electric bulbs developed by the licensees.<sup>23</sup> Enterprises outside the cartel are of course barred from the use of the patented technology employed by the cartel members, but they are also excluded from the use of technology on which patents are held by cartel members and which is withheld from use. Attention has already been called<sup>24</sup> to research which is directed at lowering the quality of products so that cus-

<sup>22</sup> *Hearings*, Temporary National Economic Committee, 75th Congress, Vol. II, p. 1023.

<sup>23</sup> See Edwards, *Economic and Political Aspects of Cartels*, p. 34.

<sup>24</sup> Pp. 547-549.

tomers who have been forced to pay high prices can not buy the identical products through other channels at substantially lower prices.

Combination has at times been defended on the ground that it permits the closing-down of inefficient and high-cost plants and the concentration of all production in the low-cost plants. It is stated, for example, that the uniting of some 228 German potash mines into a combine made it possible to shut down 120 of these mines until 1953 and to hold 45 more mines in reserve, so that in 1928, with only 63 mines in operation, Germany was producing 40 per cent more potash than in 1913 when all of the mines were in production. This resulted in markedly lower expenses.<sup>25</sup> But perhaps more frequently, combination prevents the abandonment of high-cost enterprises. Since the aim of cartelization is to share the available business among all members, the least efficient obtain a share of the market upon the same basis as the most efficient. Cartel price policy endeavors to set prices which are mutually satisfactory, and this means that they must be acceptable to the high-cost enterprises. Unquestionably, the closing-down of selected plants is more easily accomplished by the combine than by the cartel.

Because cartel policies are always in danger of being disrupted by the activities of independent enterprises, it is inevitable that cartel members should seek ways of weakening independents. The means available to international cartels for weakening independents are similar to those utilized by domestic combinations: price-cutting by the cartel in the territories of recalcitrant independents; exclusive dealer contracts, whereby distributors, in order to get permission to handle certain desirable cartel articles, must agree to handle *all* and *only* cartel products, even though other independent products may be every bit as good as the cartel products, or better; concerted efforts by cartel members to cut off supplies of raw materials to independents; concerted refusals by cartel members to grant to independents licenses on cartel-controlled patents or to permit them to have access to "know how"; harassment of independents by litigation or threats of litigation, especially trade-mark and patent infringement litigation; and many others.

<sup>25</sup> Louis Domeratzky, *The International Cartel Movement*, p. 20.

## 554 International Trade and Commercial Policy

### INTERNATIONAL COMBINATIONS AND THE TARIFF

In the allocation of national trade territories and industrial fields among the members of a combination, international combinations possess a powerful instrument for the control of international trade. Such allocations enable an international combination to carry out its own private international trade policies, although these private policies may modify, or even run counter to, the official commercial policies of the states concerned. Cartel agreements may prohibit the importation of specified articles into a particular country by reserving that national market for the domestic members of the cartel, even though the government has imposed no tariff duties upon imports of the specified articles. Under an agreement between du Pont and Imperial Chemical Industries, which controls practically the whole chemical industry of Great Britain, I. C. I. recognizes the United States market as the exclusive territory of du Pont for patented products, and actually abstains from selling here unpatented products as well, while du Pont recognizes the British Empire, with certain exceptions, as the exclusive territory of I. C. I. Thus, imports of British chemicals are virtually excluded from the United States and imports of American chemicals are virtually excluded from the British Empire market, not by the policy of the American or the British government, but by the private agreement of two great chemical concerns. As a matter of fact, international cartel agreements, while they remain in effect, and if they include all producers, give domestic producers more complete protection against foreign competition than do tariffs, for foreign producers can always evade the tariff by setting up factories inside the tariff wall.

Tariffs are commonly employed to encourage the development of, or to maintain, manufacturing within a country, while cartel agreements have at times limited or discouraged the manufacture of certain articles in particular national markets. Before the second World War, cartel regulations seriously curtailed the production in the United States of such vital war materials as magnesium, tungsten carbide, and quinine, and effectively prevented the development of an independent diamond-cutting industry here. Adjustments of tariff schedules by governments, or other official activities that

have as their purpose the encouragement of specific imports or the stimulation of certain exports, may be brought to naught by cartel agreements which are inconsistent with such official endeavors. The reciprocal trade agreement of 1939 with Canada, among other changes, reduced American import duties on aluminum; but, despite the lower duties, no Canadian aluminum flowed into the American market. It will be recalled that the Canadian aluminum monopoly, Aluminum, Ltd., is controlled by the same three families that control the Aluminum Company of America, also that Aluminum, Ltd., is a member of a world aluminum cartel no member of which outside the United States received a quota in the American market. American government officials endeavored in 1934 to increase the export of American radio sets to Sweden, where large radio imports indicated a rapid expansion in the use of radios; during this period of large imports of radios into Sweden, exports of American sets to Sweden had been negligible. The official American efforts to increase radio exports to Sweden met, however, with little success. Investigation revealed the existence of a cartel agreement among major producing companies dating back to 1925, under which the principal American manufacturers recognized Sweden as the exclusive territory of Dutch manufacturers.<sup>26</sup>

Since private cartel arrangements may afford the same relief from foreign competition that is provided by protective tariffs, may, indeed, provide more effective protection than tariffs, it might be expected that the formation of international cartels would set the stage for a lowering of tariffs. But rarely has the signing of a cartel agreement resulted in the lowering of tariff duties. On the contrary, the promotion of *higher* national tariffs has often been the policy of cartel participants. The reasons for cartel support of protective tariffs are numerous. (1) Tariff protection strengthens a cartel member in his negotiation with foreign members for a larger share of the world market, since outside members cannot export into the protected market but the protected member can export to unprotected markets. (2) International sales agreements are frequently formulated on the basis of the commercial possibilities resulting from the protection afforded by existing tariffs, the removal or substantial reduction of which would greatly weaken, perhaps to the

<sup>26</sup> Edwards, *Economic and Political Aspects of Cartels*, p. 45.

## 556 International Trade and Commercial Policy

point of dissolution, many international cartels. (3) A combination may fail to eliminate all competitors. A tariff gives protection against outsiders who do not cooperate with the combination and against cartel members who undertake price wars as a disciplinary device. (4) While an international combination may give its members completely satisfactory protection against foreign competitors, the life of the combination is usually not permanent. The cartel agreement may have been limited originally to a given term of life, or the cartel may collapse, either from internal dissensions or because of the appearance of new competition. The maintenance of protective duties provides insurance against the collapse of the cartel, and it is always easier to retain duties already in effect than it is to regain them once they have been surrendered. (5) Even if cartels were willing to abandon tariffs, governments might be unwilling to do so. Tariff reduction or the removal of the tariff may threaten a loss of revenue which the government feels it can ill afford. Furthermore, countries with double-schedule tariffs establish their conventional duties through a process of bargaining, and are unlikely to be eager to weaken a strong bargaining position by a voluntary additional reduction of duties. All these reasons go far to explain why international combinations are not, and are unlikely to become, advocates of low tariffs.

Certain restrictive policies of cartels may be responsible for the erection of trade barriers which are wholly undesired by the cartels. It has been a consistent policy of many cartels to use every conceivable means to deter the industrial development of non-industrial countries, which are referred to by cartels as colonial markets. Efforts by the governments of Mexico, Brazil, Argentina, and other Latin-American countries to encourage the domestic production of soda ash and other chemicals, for example, have been countered by temporary price cuts by the cartels in the colonial markets and by delaying cartel investigations that seek to explore the possibilities of colonial industrial development. Where such tactics have failed, the cartels have attempted to retain control over colonial production by bringing the Latin-American producers into the cartel, to limit the size of projected plants, and to restrict colonial output by means of manufacturing quotas. Because cartel policies that seek to discourage industrial development in non-industrial countries are in

direct contradiction to the aspirations of the governments of those countries, it is probable that such cartel policies bear a large share of the responsibility for the enactment of Latin-American legislation that is hostile to foreign imports and insistent upon domestic control of many types of enterprises.

#### POLITICAL ASPECTS OF CARTELS

While the policies of a cartel are frequently at variance with those of a particular government, the two are at times brought into harmony. Politically dominated cartels may become the instruments of the commercial policy of particular governments. During the reign of National Socialism in Germany, various cartels dominated by German concerns were used by the German government to maintain German exports, at the expense of other countries, and to assure the German economy supplies of foreign exchange. Business-minded cartels, on the other hand, strive to induce governments to adopt trade restrictions which supplement cartel regulations. The French government has upon more than one occasion invoked its powers over import duties and quotas to promote cartel agreements or to enforce cartel policy.<sup>27</sup>

Since cartel restrictions are intended to serve the interests of cartel members at the expense of outsiders, it may well happen that an international cartel expresses the collective national interests of producing countries in its exploitation of consuming countries. When cartels are international, however, it is to be expected that they would resist the subordination of cartel policy to the national policy of any particular producing country. But, when a cartel is dominated by the enterprises of a single nation, the economic control exercised by the cartel may assume a distinctly political hue, so that the cartel's activities reinforce and supplement the activities of the national state in which the dominant enterprises are domiciled. The chances that the cartel will be used for national ends are strengthened if the member enterprises of one of the nations are politically minded while those of other nations are concerned primarily with their private business interests. In the United States, where there is a deep-rooted business tradition of freedom from government control, business sentiment is universal that "an inter-

<sup>27</sup> For examples, see *ibid.*, pp. 46-47.



## 558 International Trade and Commercial Policy

national business operating throughout the world should conduct its operations in strictly business terms, without regard to the political beliefs of its management or the political beliefs of the country in which it is operating." In Germany, on the other hand, where the distinction between business and government has been progressively obscured, many business leaders have agreed that "an international cartel has no right of existence and a German businessman has no right to become a member of such a cartel if this cartel is acting against the common interests of Germany."

Where cartel members of a particular nation come under the control of an aggressive government, trade relationships may be manipulated for diplomatic and military, rather than for strictly economic, ends and thus endanger the national security of other peoples. After the Nazi government came into power in Germany, German members of cartels became increasingly subject to the control of the state, and, with outside cartel members indifferent to political developments and sometimes subservient to German enterprises, cartel activities were directed more and more to the rearming of Germany and to the weakening of states which were likely to oppose German national policy. To businessmen in the United States, Great Britain, and France, international cartels were an efficient means of shackling competition and of guaranteeing monopoly control—with its restricted output, high prices, and maximum profits; so long as these ends were met, no great concern was felt over the political and diplomatic implications of cartels. German businessmen, to whom international cartels were at all times the servants of German interests, thus found it relatively easy to weaken—through patent controls and cartel agreements—the military potential of its prospective enemies. Cartels were used extensively by Germany as agents of political propaganda, for the collection of vital information about foreign industries, and to suppress the development of strategic industries in countries which might become hostile to Germany.

In Latin America, Sterling Products and I. G. Farbenindustrie used their advertising as a political weapon. Advertising was withheld from anti-Nazi newspapers or was immediately withdrawn from papers which shifted to an anti-Nazi position, while newspapers favorable to the Nazi cause were rewarded with generous

advertising allotments. American agents of German chemical concerns were mailed copies of Hitler's speeches with the request that they be circulated among "your circle of acquaintances."

The American Bosch Corporation supplied Robert Bosch Co. of Germany, which at the time owned a majority of American Bosch Company stock, with information concerning developments in short-wave and high-frequency radio; these developments became the basis of inter-tank, ground-air, and infantry radio communication in the German army. This information, based upon experimental work in United States Army and Signal Corps laboratories, was acquired by American Bosch through the receipt of drawings and specifications which were supplied to concerns on the approved bidding list of the American armed forces.<sup>28</sup> Under cartel agreements, the American manufacturer of military optical instruments, Bausch & Lomb Optical Company, exchanged information with the German producers, Carl Zeiss and Bausch & Lomb of Frankfurt, concerning domestic deliveries of such military equipment as range finders, periscopes, and telescopes; this exchange of information was apparently continued even though American Bausch & Lomb was sworn to keep all military information received from the United States government confidential from all outsiders.<sup>29</sup> German concerns in possession of military information were usually more careful to prevent the transmission of secrets abroad, especially under the Nazi government. The Bavarian Motor Works produced air-cooled aviation engines under a license from Pratt & Whitney which provided for a royalty of \$200 per engine and for semi-annual statements concerning the number of each model manufactured, shipped, sold, leased, or used. In order to conceal from foreign agents the number of engines manufactured, the Bavarian company in March, 1934, insisted upon a modification of the royalty provisions of the agreement in the form of the substitution of a lump-sum annual royalty of \$50,000; such payment would divulge to the American licensor nothing relative to the German production of aircraft engines.

Cartels proved to be a most effective device for preventing or limiting the production outside Germany of some of the most im-

<sup>28</sup> *Ibid.*, pp. 56-57.

<sup>29</sup> *Ibid.*, p. 57.

## 560 International Trade and Commercial Policy

portant new materials of war. These restrictions were, of course, necessary consequences of such characteristic cartel policies as the limitation of output and capacity as well as the suppression of technology, but there seems little doubt that ordinary monopoly practices were in many cases supplemented by deliberate military planning by the German authorities. How the development of magnesium production in the United States was restricted by cartel agreements between I. G. Farbenindustrie, the Aluminum Company of America, and Dow Chemical Company so that in 1938, when German production had reached 12,000 tons annually, American output was kept at only 2400 tons has already been told. Other vital war materials whose output was similarly retarded include synthetic rubber, quinine, tungsten carbide, military optical instruments, and beryllium. The role of cartels in such restrictive activities has been forcefully stated by Borkin and Welsh:

Wherever there was a cartel before, in 1942 there was a military shortage. The Army and Navy petitioned civilians to turn in binoculars and lenses. The Baruch Committee reported that if we do not solve the synthetic rubber problem, we face a "civilian and military collapse." The gallant stand of MacArthur's men on Bataan became more desperate because they found themselves without quinine. The growing priority lists of chemicals and plastics were an inventory of cartels. When we tried to tool up our new factories, with every second of time working against us, the lack of tungsten carbide blunted the edge of our effort. This roster of scarce materials and the absence of substitutes have a common cause.<sup>80</sup>

The restriction of American output was a means of crippling the military preparation of more immediate enemies than the United States. In 1935, the British and French governments tried to order \$1,500,000 worth of range finders, gun sights, periscopes, and fire control instruments from Bausch & Lomb, but the latter refused to handle the orders. According to Dr. Bausch, founder and chairman of the company, the company's refusal to consider the British and French orders was dictated by a company policy, through an understanding with the Army and Navy, whereby Bausch & Lomb was

<sup>80</sup> Joseph Borkin and Charles A. Welsh, *Germany's Master Plan*, p. 13. Reprinted by permission of the Publishers, Duell, Sloan and Pearce, Inc. Copyright 1943 by Joseph Borkin and Charles A. Welsh.

not to sell to foreign powers instruments which might conceivably be used against the interests of the United States!<sup>81</sup>

Whether patents and processing agreements between United States and German corporations, on balance, fettered American war production is, however, an open question. To give a fair judgment, one would have to know the value of the technical knowledge disclosed by each side to the other and the uses to which this knowledge was put. The public has been given much more information regarding the disclosure of American technical knowledge to German firms than of German technical processes to American firms. Officials of the Standard Oil Company of New Jersey, for example, have stated that the technical knowledge concerning the manufacture of synthetic rubber secured from I. G. Farbenindustrie was very important in the rapid building-up of the American synthetic rubber industry.

The outbreak of war in 1939 necessitated the modification of pre-war cartel arrangements. Cartel members in neutral countries had to determine how far they would collaborate in proposals made to serve the interests of one belligerent as against the other; members in belligerent countries had to decide to what extent trade connections might be maintained without the violation of laws against trading with the enemy. In practically all cases in which cartel connections were suspended, in whole or in part, such suspension was made in contemplation of the full renewal of the agreements as soon as political conditions might permit, and, insofar as it was feasible, the interests of cartel partners, whether neutrals or enemies, were safeguarded. In some cartels in which the relations of German and American partners were close, American companies undertook to serve their German partners, and incidentally safeguard their own cartel interests, by minimizing the effects of British measures to blockade enemy trade. Where the Germans had formerly enjoyed exclusive rights in South American markets, American partners were granted permission by German cartel members to supply the South American customers during the war—but on the condition that American sellers agree to withdraw after the emergency. In certain instances, the American partner assisted the German firm in obtaining supplies for shipment to Germany or in borrowing funds

<sup>81</sup> Edwards, *op. cit.*, pp. 61-62.

## 562 International Trade and Commercial Policy

abroad. In various industries, transfers of property and assignments of patent rights were made in order to convert foreign property into domestic property. Such property transfers seem to have been consummated, first, to avoid the difficulties of wartime communication by transferring to each member of a cartel the control over properties to which that member had easy access and, second, to conceal the foreign ownership of properties in order to forestall the possible application of freezing regulations, seizure by Alien Property Custodians, or other impairment of property rights in the interests of national policy.

Cartelization, with its continuance of mutual loyalties and joint property interests, which unite concerns on opposite sides of the battle line, constitutes an obvious danger to national security in wartime. Cartel connections with enemy nationals afford a constant incentive for the qualification of allegiance to one's own nation. The maintenance of contacts with enemy concerns through concerns in neutral countries provides a standing opportunity to domestic concerns to promote their trade interests by transmitting information, and even supplies, which may be of value to the enemy. For the great international combine with subsidiaries and affiliates located in territory controlled by the enemy, the motives to compromise are strong. After all, the desire to protect property and profits is natural. There is a strong hope that the property rights of private citizens will be respected so long as they do not interfere with military operations, that with the restoration of peace property values and profits will be reestablished by the revival of international trade and investment. And it is realized that refusal by any branch of the combine to cooperate with the belligerent government dominating the country of its residence will only lead to enforced collaboration and the futile sacrifice of property rights. It is known, furthermore, that upon occasion belligerent governments have tacitly consented to the barter of goods with enemy countries through neutral intermediaries. "With the steady pressure of self-interest on the one side, and the inherently complex character of patriotic duty on the other, it is easy for the directors of a corporate combine to persuade themselves that there is no treason in the pursuit of an obvious business advantage."<sup>82</sup>

<sup>82</sup> *Ibid.*, p. 71.

## CONCLUSION

International combination might conceivably, in certain instances, bring lower costs of production as a result of the abandonment of high-cost plants, the elimination of wasteful competitive practices, the pooling of patents and "know how," or a more methodical organization of production in general. But even where combination succeeds in abolishing wasteful competition or in achieving economies in production, there is little reason to expect that the benefits therefrom will be passed on to the consuming public in the form of lower prices or improved quality. On the contrary, experience has taught that combination results almost inevitably in the retardation of technical progress, the exploitation of consumers through higher prices and deteriorated quality, and the abuse of a monopolistic position for steadier and larger profits for producers. And, besides, there are strong grounds for the belief that the optimum size of a business concern is attained far short of international monopoly—or even of national monopoly, for that matter. The ends of peace call not for continued constraints on production and consumption, but rather for an expansion of both in infinitely varied and unstandardized forms, including economic security in reasonable balance with liberty and progress. Any increase in living standards must wait upon the expansion of production, the promotion of international trade, the economic development of colonial areas, and the curbing of politico-economic nationalism. In such a program, there is no place for restrictive, private cartel policies.<sup>33</sup>

There are those who insist that American participation in international cartels is necessary in order to maintain or increase our exports. By local price cutting, the monopolization of distributing outlets, and other practices, fair and unfair, foreign cartels can, it

<sup>33</sup> Professor Edward S. Mason points out that cartel restrictions may have, on occasion, increased the total volume of world trade. "High cartel prices have frequently brought productive capacity into the market, as well as a greater volume of exports than would have otherwise existed. If an international cartel prevents the installation of domestic productive capacity by threatening to cut prices in a particular country, imports into that country may be maintained and, along with them, world trade. This result has been achieved on more than one occasion in Latin-American countries. Such expansion of trade, however, is not likely to be adduced as a merit of cartelization." "The Future of International Cartels," *Foreign Affairs*, Vol. XXII (1943-1944), p. 608.

## 564 International Trade and Commercial Policy

is alleged, effectively deny certain foreign markets to certain American products, whereas if American firms were members of the cartels, access to these markets would be secure. This argument is not very convincing. High cartel prices abroad offer excellent competitive opportunities to American enterprise; it is probably true that cartel practices have resulted in the loss of more business to American competition than they have gained.

It is easy to see the dangers of cartels, but difficult to know what to do about them. Abroad, there has been active public discussion of postwar policy toward cartels, and, while their most earnest advocates have conceded that such organizations should be checked by requirements that cartel agreements be made public, or be subject to explicit government sanction, there is a substantial propaganda, particularly in England, for the extension of the cartel system under a minimum of public supervision. It is to be hoped that the nations of the world may be able to agree on international action to direct public policy toward the removal or reduction of barriers to trade, both governmental and private, and that the council of nations may find some way to curb cartels and their restrictive policies. (See the discussion of the proposed International Trade Organization below.) But in the absence of international action, and the obstacles to such action are great, each country must consider whether it can protect its interests against cartel restrictions by independent action.

Since an international cartel cannot operate effectively in a nation in which it does not possess a monopoly, a nation which produces, or can produce, enough of any particular commodity to meet the demands of its consumers can protect its consumers from the restrictive policies of international cartels by assuring the independence of its own domestic enterprises. This has been the traditional policy of the United States since 1890. Despite the qualified success of American antitrust policy, it seems highly desirable that this policy be not only continued, but strengthened. Vigorous enforcement of existing laws will put monopolies on the defensive and compel them to watch their step. Antitrust legislation should be amended in such ways as would give it sufficient flexibility to meet new conditions as they arise. The suggestion that all corporations engaged in interstate and international commerce be required to be

federally incorporated is also worthy of consideration. The enforced renewal of federal charters at stated periods would permit careful scrutiny of corporate activities by a public body, and would give to the public a veto over those activities that threaten to compromise the fullest production and employment permitted by the current level of technology, the availability of materials, and the labor supply. Revision of our patent laws is obviously needed which will, if possible, retain the incentive to inventors but at the same time prevent the use of patents to restrain trade or restrict output. There is merit in the suggestion that patents as such be completely abolished, that a royalty for the inventor be substituted therefor, and that all companies, upon the payment of such a royalty, be permitted free use of the new device and free opportunity to develop new techniques, new products, and new processes. Where other means of curbing domestic monopoly fail, the government's power to compete might be called into play. Government ownership of billions of dollars worth of war plants places the government in a strong position to compete. Government-owned plants need not necessarily be operated in all cases by the government; they might be rented by private contractors, but under such conditions that practices detrimental to the public shall not prevail. In Sweden, and in the case of the Tennessee Valley Authority, public competition has been effectual. Government competition should be invoked, however, only as a last resort, when other means of curbing restrictive cartel policies fail; and any form of public subsidy to government plants as such should be scrupulously avoided.

Where the domestic market depends almost entirely upon *foreign* sources of supply, as the American market does for tin, nickel, quebracho, cinchona bark, industrial diamonds, and natural rubber, unilateral action is less likely to be effective. Direct efforts to assert authority over foreign enterprises which supply the domestic market can accomplish little if these enterprises can conduct their business in such a way as to deprive the government of the importing country of jurisdiction over them, as, for example, when foreign cartel members surrender title to their products before they reach the national border rather than operate through domestic branches. Unilateral defensive action in such cases might be found in authority to withhold from foreign offenders governmental grants



## 566 International Trade and Commercial Policy

of privilege, such as the issuance of patents or the recognition of trade marks, control over imports and over the export of capital, pressure on foreign concerns through their home governments, or private and governmental action to diminish the dependence of the domestic market upon foreign supplies.<sup>84</sup> In fields where the rest of the world depends upon the producers of a particular country for a substantial part of its supplies, the policy of that country toward its own exporters will go far to determine the success of international cartels.

There are many planners today who hope to guarantee the stability of prices, assure more orderly production, reduce economic fluctuations, promote full employment, facilitate international trade, ensure free access to raw materials, and raise consumption levels by means of a whole network of international commodity agreements.<sup>85</sup> Such an ambitious scheme warrants earnest study. But it must be remembered that multilateral, international commodity agreements of the past have been unable to resist the regulative restriction of production and export for the sole purpose of protecting existing investment or coddling producers. They have been oblivious to the interests of consumers, but have, rather, protected the strong against the weak and obstructed competitive adjustments making for lower production costs. If international commodity agreements are to win the sanction of the peoples of the world, they must give promise of ready modification to meet changing conditions, of facilitating technological progress, of ensuring free and equal access

<sup>84</sup> Corwin Edwards, *American Economic Review*, Supplement, March, 1944, pp. 338-339.

<sup>85</sup> In September, 1945, the British Fuel Minister and the United States Petroleum Administrator for War signed an agreement which it is hoped will lead to an agreement among all the governments of the world interested in the production and consumption of petroleum for the orderly development of the international petroleum trade. Pending the signing of such a multilateral agreement, the two signatory governments agree to establish a joint commission, one of whose chief functions shall be "to prepare periodic estimates of world demands for petroleum and of the supplies available for meeting the demands, and to report as to means by which such demands and supplies may be correlated so as to further the efficient and orderly conduct of the international petroleum trade." This agreement has not yet received ratification by the United States Senate (December, 1946). The 1945 agreement superseded an earlier Anglo-American agreement on petroleum, signed August 8, 1944, which was never brought into force.

to foodstuffs and raw materials wanted by deficit countries, of avoiding distortion of the world's productive resources, of preventing the piling-up of unwanted surplus stocks, and of assuring full employment of resources with constantly rising standards of consumption. Agreements among private producers give no promise of attaining these goals. There is no reason to expect that even the participation of government producers, or governments that represent producers, in cartels will bring about the effective regulation of cartel output and price policies in the interests of groups broader than those composed of cartel members. Governments will sponsor and regulate cartels with an eye to the exports of their nationals. The more important the export interests are in a country, the more actively will the government support cartels and the less will it consider anything other than export interests when it does.<sup>36</sup> The search for methods of international agreement, cooperation, and regulation that will promote the peaceful progress of the world economy will be long and arduous. But certainly, no agreements can reach these goals which do not grant important rôles to governments, and especially to consumers.

The guarantee of the adequate representation of consumer interests on international planning boards is, however, difficult—to put it mildly. Consumers' representation on the governing boards of such controls must be entrusted to government representatives. But governments have not yet been able to free themselves from the influence of the specious pleas in favor of "stability" put forward by producer interests to such a degree as to justify any confident expectation that government defense of consumers would be as effective as the stimulating influence of competing producers prepared to offer goods of satisfactory quality at prices lower than those which vested interests find to be comfortable. Furthermore, the influence of the more powerful national economies in world affairs, will always be very great. Just as planning within a national economy may easily become an instrument for establishing more securely the influence of groups already dominant there, so planning on an international scale may be attractive as a means of ensuring

<sup>36</sup> The intervention of the state in foreign trade also introduces a possibility of political conflict which may be more dangerous to the maintenance of peace than the conflict between private cartel interests.

## 568 International Trade and Commercial Policy

that the policies of the smaller economies are adapted to meet the predilections of the larger.<sup>87</sup>

The most promising solution of the cartel problem would appear to lie in international cooperation. The elimination of most cartels by national governments on the basis of international agreement has much to recommend it; the main weakness of such procedure lies in the political obstacles to attaining international agreement. In the absence of such agreement, a permanent commission for the continuous study and regulation of cartels might be established. Such a commission might require that cartel-type agreements among corporations carrying on international trade be registered with the commission; the information obtained could then provide the basis for more comprehensive regulation by member governments or by the commission itself. The United States State Department proposed a meeting of the United Nations for the late autumn of 1946 to consider the establishment of an International Trade Organization, which would contain a special agency to receive complaints concerning the restrictive practices of international cartels, collect and examine the facts relevant to such cases, and advise the Organization as to the remedies that may be required. Pending the establishment of such an organization, the United States government might well require the public registration of all agreements under which our nationals participate in international cartels.<sup>88</sup>

The basic problem underlying the formation of both international industrial cartels and agricultural commodity agreements can be met, in large measure, by diminishing the fluctuations of the business cycle and achieving a relatively high degree of economic stability at high levels of employment. Cartels come into being primarily as a result of excess productive capacity. If violent cyclical fluctuations could be largely eliminated, a major cause of excess capacity—and of restrictive cartel policies—would be removed.<sup>89</sup> The promotion of the reasonably full employment of resources rests

<sup>87</sup> See the stimulating discussion of this point by Allan G. B. Fisher in *Economic Progress and Social Security*, London, 1945, pp. 279–289.

<sup>88</sup> See Calvin B. Hoover, *International Trade and Domestic Employment*, pp. 74–83.

<sup>89</sup> See Alvin H. Hansen, *America's Role in the World Economy*, Ch. XXI, and Edward S. Mason, "The Future of International Cartels," *Foreign Affairs*, Vol. XXII, (1943–1944) pp. 614–615.

upon the adoption of proper domestic economic policies, especially by the major industrial countries, and the international coordination of national policies through international agencies. Anti-depression and full-employment policies, on both a national and an international scale, are discussed in Chapter XXVII.

### FOOD AND AGRICULTURAL ORGANIZATION

A Food and Agricultural Organization has been established within the framework of the United Nations to attack the three great scourges of mankind: rural poverty, malnutrition, and ill health. Its purposes are stated to be to promote the common welfare and contribute toward an expanding economy by raising levels of nutrition and standards of living of the peoples of the world, by improving the efficiency of production and distribution of all food and agricultural products, and by bettering the conditions of rural populations. The proposed functions of the Organization fall into three classes: (1) the collection, analysis, interpretation, and dissemination of information relating to nutrition, food, and agriculture; (2) the promotion and recommendation of national and international action with respect to scientific, technological, social, and economic research in these fields, the improvement of education and administration, and the spread of public knowledge of nutritional and agricultural science and practice; and (3) the handling of practical problems relating to the conservation of natural resources, the adoption of improved methods of agricultural production, the processing, marketing, and distribution of products, the provision of adequate national and international credit, and the formulation of policies with respect to agricultural commodity arrangements.

The Organization is to be prepared to furnish technical assistance to governments upon request, and to organize in cooperation with the governments concerned missions to assist them in carrying out the recommendations of the Conference (the main organ of the new agency). Its necessary research will cover a wide range of subjects in the natural sciences, technology (irrigation, drainage, and other conservation measures), the economic aspects of agriculture, and the study of social factors, such as the distribution of population between agriculture and industry, population movements, land tenure, food habits, rural housing and sanitation, rural schools, and

## 570 International Trade and Commercial Policy

rural electrification. The work of the Organization will not be confined to agricultural food products; it will also include fisheries, forestry, and nonfood agricultural products.

The Organization has set up a special commission to prepare detailed plans for a world food board and an international price-stabilization plan. It seems reasonable to expect that the Food and Agricultural Organization will become an important factor in any international agency that may be devised to consider international commodity agreements.

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## *Merchant Marine Policies*

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The maritime industries—shipping and shipbuilding—hold a unique position in international trade. The shipping industry furnishes transportation for the bulk of the commodities moving from nation to nation,<sup>1</sup> while the shipbuilding industry produces the ships to carry the goods. Conversely, despite the employment of many vessels on inland waterways and in the coastwise trade, it may fairly be stated that the world shipping industry depends to a large extent upon international trade. Shipping services, furthermore, are themselves an object of international commerce and as such enter into the balance of international payments. Carrying services rendered to foreigners are an export; those obtained from foreigners, an import. To some of the major maritime nations, e.g., Great Britain, Japan, Norway, Germany, and Greece, the earnings of the merchant marine have been an important source of foreign exchange; shipping earnings have been one of the invisible exports which have made it possible for Great Britain to enjoy an import balance of merchandise trade for decades.

The more efficiently shipping services are rendered and the lower the shipping charges can be brought, the wider becomes the range and the greater the volume of international commerce; for, as has been explained in an earlier chapter, transport costs constitute the major natural obstacle to trade—and the higher the costs of transport, the greater the obstacle. Like any other industry, shipping without artificial restraints or encouragements would be conducted by those nations which are peculiarly adapted for it, and shipping

<sup>1</sup> Between countries that are contiguous, railroads and even trucks today account for much of the traffic; in the future, many goods of high value will probably be transported by airplane.

services would be bought (imported) by the other nations which are relatively poorly fitted for it. The same would be true of shipbuilding. If shipping and shipbuilding were not subsidized, nor artificially restricted, shipping services would be provided at the lowest costs compatible with existing technology, and world productive factors would be organized in the most economical pattern.<sup>2</sup>

But governments have not been content to let the world merchant marine develop according to the principle of comparative advantage. Instead, practically every nation with access to the sea has resorted to a variety of artificial stimulants to develop a merchant marine of its own. For shipping is not a business in the usual sense of the term; it is an instrument of national policy. No single industry has been so shaped by considerations of nationalism as has the shipping industry, and its auxiliary industry, shipbuilding. The possession of a national merchant marine has almost universally been deemed indispensable to the national pride and honor, regardless of how cheaply shipping services may be obtained from the merchant fleets of foreign countries or how great the cost of maintaining a merchant fleet of one's own may be to the public treasury. The pleas of ardent nationalists for the maintenance of a national merchant marine stress the value of such a fleet as (1) a military and naval auxiliary in time of war, (2) an instrument to promote the political and economic interests of the nation, and (3) a means of better serving the foreign trade of the nation.

#### THE CASE FOR A NATIONAL MERCHANT MARINE

(1) *Military and Naval.* The maritime industries have always been important in the economy of national defense, especially since ships are capital goods which cannot be quickly built nor readily purchased in time of war. With the development of totalitarian warfare involving long-range economic planning, military and naval considerations have played a role of increasing importance in the navigation policies of all major world powers.

Merchant ships perform a number of essential functions in wartime. (1) They are essential both as transports and as carriers of

<sup>2</sup> Shipping charges should, however, reflect the full costs of the service. Otherwise, the world pattern of production will be uneconomically distorted. See F. W. Taussig, *Principles of Economics*, 3rd ed. (1939), Vol. II, pp. 418-421.



## 574 International Trade and Commercial Policy

military supplies in any important military operation requiring ocean transportation. (2) A nation's merchant marine may be the only vehicle for maintaining in time of war the overseas transportation services necessary for bringing in essential war materials and for carrying out goods whose sale abroad will provide much-needed foreign exchange and guard against glut in certain markets. The withdrawal of enemy, allied, or neutral shipping at such a time, when the demand for shipping space is multiplied, could cause a serious breakdown of the war economy if there were no national merchant marine. (3) Ships may supplement the internal transportation facilities if the latter become overloaded or break down. (4) The shipping industry may earn considerable foreign exchange in wartime, if it is given adequate naval protection, since at such a time freight rates are almost sure to be high. But belligerent vessels generally work under greater handicaps than do neutral vessels. (5) Merchant ships may contribute directly to naval power, either as combat vessels or as supply and special-service vessels.

During the American Revolution and the War of 1812, American merchantmen were extensively armed as privateers and inflicted heavy losses upon the British merchant marine. Although commercial vessels are still sometimes used as auxiliary cruisers, the development of explosive shells and armor plate and the high degree of specialization in modern naval vessel design has diminished the importance of commercial ships as potential naval vessels. Large, fast liners may be reconverted into aircraft carriers or fitted out as auxiliary cruisers, but unarmored cruisers are highly vulnerable. The modern battle fleet, however, requires a large number of supply vessels, the most important of which are tankers, fast enough to accompany the fleet. Small cargo ships, trawlers, and tugs are useful as mine sweepers, anti-submarine vessels, and decoy ships.

Although a foreign trade fleet may add materially to a nation's fighting power, such a fleet itself is in constant need of protection. A merchant fleet which is not free to operate upon the high seas avails a country little, and freedom upon the high seas can be assured only by the establishment of naval supremacy. During World War I, the magnificent German merchant fleet proved of no value to Germany because her ships were unable to break through the blockade established by the British Navy, and American shipping

was almost completely driven from the seas by the British Navy both during the Revolutionary War and the War of 1812. The world's greatest navy was unable to protect the British merchant fleet and maintain the flow of vital supplies to the British Isles in 1917 and again in the years 1940-1942 without the assistance of allied navies. The need of a strong navy to protect commerce and shipping has been one of the major arguments of naval strategists from the days of Mahan. Thus the creation of a foreign trade fleet to strengthen the navy results in a demand for a still larger navy in order to protect the newly established merchant shipping!<sup>8</sup>

(2) *To Promote the Political and Economic Interests of a Nation.* A national shipping network can be maneuvered to influence the location of economic activities and to stimulate the commercial and industrial development of the country. Production tends to become localized with reference to such basic economic factors as sources of materials, markets, population, and natural transportation facilities. Frequently, however, towns and cities have grown up at strategic points along railroad and shipping routes, and junction and transshipment points have become important producing, marketing, and redistribution centers which have in turn attracted other industries, such as banking, retailing, and public utilities.

If shipping policy is passive, sea communications will develop merely to serve existing centers. But if shipping policy becomes a tool of national policy, transport relations may be moulded so as to guide the location of production, marketing, and consumption centers. This may be done by laying out shipping routes and by controlling costs of shipping services. The influence of the shipping industry on the world localization pattern has been increased by the widespread use of the government subsidy, which usually takes the form of a contract specifying a particular route.

In the past many nations have taken strong measures to place themselves at a focal point of a network of shipping services radiating to all important world economic areas, in order to improve their transport relations and thus to increase their importance as commercial and manufacturing centers. Indeed, a very considerable proportion of the history of shipping policy is concerned with the efforts of nations actively to develop

<sup>8</sup>This point is more fully developed by Paul M. Zeis in *American Shipping Policy* (1938), pp. 232-236.

## 576 International Trade and Commercial Policy

such networks. Great Britain, in particular, was remarkably successful in developing an extensive shipping network in the last half of the nineteenth century. This system was based on supplies of cheap and excellent steamships and abundant capital, and on the economies of scale and the prestige which her operators secured. At the core of the network were large contract mail carriers, each of which served a major economic region. This network widened the British markets both in buying and selling, doubtless promoted the rise of British industry by increasing the scale of operations, and brought benefits to British firms overseas in the form of increased prestige, business connections, and opportunities for investment. . . .<sup>4</sup>

More recently both Italy and Japan have made themselves focal points of many ocean transportation routes.

(3) *A Means for Promoting and Insuring the Foreign Trade of a Nation.* It is frequently argued that a foreign trade fleet promotes and protects the commerce of the nation during times of peace and affords a means to insure the continuance of profitable neutral trade and the maintenance of normal commercial relations when other nations are at war. Ever since the Civil War, American shipping interests have been urging government aid to shipping on the ground that American exporters were handicapped because of inadequate shipping facilities to South America and the Orient. They have claimed that American carriers would have a special interest in promoting the sale of domestic products, whereas foreign companies would discriminate against American exporters and favor the exporting interests of their own countries. It has also been alleged that a national merchant marine protects domestic shippers against exorbitant rates.

Most of these arguments are of doubtful validity, and several have been demolished by the Maritime Commission.<sup>5</sup> The Commission did contend, however, that American vessels in a given trade tend to improve the service furnished American exporters and importers, and to support its contention cited the situation which prevailed before the first World War, when it was claimed that American exporters suffered from the lack of direct, fast steamers to the

<sup>4</sup> John G. B. Hutchins, *The American Maritime Industries and Public Policy, 1789-1914*, Harvard University Press, 1941, p. 12.

<sup>5</sup> United States Maritime Commission, *Economic Survey of the American Merchant Marine* (1937), pp. 5-9.

Orient and South America. It is doubtful whether this contention ever had any substantial validity,<sup>6</sup> and the Commission itself admitted that the deficiency was remedied after the War. Now that sufficient export to these areas has been built up to encourage the establishment of direct line services, it seems almost certain that these services would be continued by foreign shipping even if American vessels were withdrawn. Between the two World Wars the shipping tonnage of the world actually exceeded the requirements of world trade. This surplus will probably be increased rather than reduced in the future because of the unprecedented construction of seagoing vessels during World War II and the willingness of most maritime nations to subsidize shipping. Such an excess is an almost certain guarantee that, wherever there are products to be shipped, there will be carriers eager to secure the business.

There is little evidence to substantiate the charges often made that foreign ships discriminate against American commerce by failing to handle our products promptly and efficiently, by making excessive freight charges, or by passing on to exporters in their own countries names of our customers and other trade secrets. A Congressional investigating committee found no discrimination against American exporters by foreign shipping interests in 1913, and there is little probability that any developed in later years. Shipping is so highly competitive, and there are so many services available under different flags that the individual operator cannot afford to practice discrimination against a customer. Should the shipping companies of any nation attempt to discriminate against American exporters in favor of their own nationals, American shippers have the opportunity to ship in the ships of other nations.

The evidence that American shipping companies have endeavored to protect American shippers against exorbitant shipping rates, and have sought to promote American trade abroad seems hardly more convincing. Rates in general appear to have been little affected by the establishment of American lines. American lines usually join international shipping conferences set up to maintain and stabilize rates, and shippers have complained that, insofar as our lines have any influence at all in the conferences, they are more likely to stand for higher than for lower rates. Even if our lines sought to reduce

<sup>6</sup> Paul M. Zeis, *op. cit.*, pp. 25-26, 50.

## 578 International Trade and Commercial Policy

rates, they could be outvoted in the conferences where foreign lines predominate. At home, American shipping interests have fought to keep the Shipping Board fleet idle in order to sustain rates. The artificial support of an American merchant marine by means of subsidies has worked rather to injure the American export trade, since it tends to minimize the use of foreign carriers and thus to reduce the amount of dollar exchange available to foreign nations for the purchase of American products. The payment of subsidies, furthermore, increases the tax burden, a part of which probably falls upon business, and thus impairs the competitive power of American enterprises.

The Maritime Commission has asserted that "the principle advantage which accrues to our foreign commerce from the possession of a domestic flag marine is that it provides a measure of insurance against possible interruption of service."<sup>7</sup> It is true that a war creates a scarcity of tonnage, increases shipping rates, disturbs normal channels of trade, and makes it difficult for American exporters to find vessels to carry their products. But it is not certain that these war handicaps would be overcome by the existence of a domestic flag fleet. In time of war, American shipowners, as well as shipowners of foreign countries, have always shown themselves eager to take advantage of the scarcity of shipping by raising their rates and withdrawing their vessels from their usual routes for use in the more lucrative war trade. American business with the Allies during World War I certainly suffered no loss because of the lack of American ships. "Contracts compelling the private operators, in return for subsidy payments, to maintain service on certain trade routes at rates prescribed by the Government might have had some effect in minimizing the dislocation of trade during the war period, but only a huge reserve of tonnage in excess of peacetime requirements would have prevented the wartime fluctuations from occurring."<sup>8</sup>

Professor John G. B. Hutchins has pointed out<sup>9</sup> that, whereas the prevalence of the conditions essential for pure competition—numerous, small-scale enterprises, comparatively undifferentiated service,

<sup>7</sup> *Op. cit.*, p. 5.

<sup>8</sup> Paul M. Zeis, *American Shipping Policy*, Princeton University Press, 1938, pp. 223–224.

<sup>9</sup> *Op. cit.*, pp. 31–34.

ease of entry and exit—in the period of wooden sailing ships made the market criteria of rates and profits satisfactory for determining the success of navigation policy, such criteria failed to be reliable with the rise of metal steamships. Monopolistic conditions in the iron and steel industry distorted shipbuilding costs; the growth of gigantic shipping enterprises led to cutthroat competition, to rate, traffic, and territorial agreements, to the widespread use of such typically monopolistic practices as tying agreements with shippers and temporary rate-cutting on particular routes; and government subsidies to shipping and shipbuilding made it possible to set rates well below costs. By means of local price discrimination, tying agreements, the use of “fighting ships,” and other devices of unfair competition, and with the aid of government bounties, foreign merchant marines may be able to injure and even drive from the seas the ships of a given nation, which in fair competition would be quite able to hold their own against all comers. Is not a government justified, on economic grounds alone, to take whatever measures are necessary to keep its ships in operation against such tactics?

It is difficult to give a simple answer to this question, for it is complicated by the prevalence of retaliation and counter-development. Insofar as domestic shipping is handicapped by monopolistic prices on steel and other materials, the proper remedy would seem to be to take whatever measures are necessary to reestablish competitive prices for steel and other materials at home, not to tax the people still more in order to grant shipping subsidies, *unless* the subsidies can be met *wholly* from taxes on the monopoly profits of these very industries. The case for the payment of subsidies to make it possible for domestic flag ships to compete against temporary rate-cutting, “fighting ships,” and unfair methods of competition is much stronger. The only purpose of such tactics is to force competitors out of business so that the victors may thereafter have a free hand; to maintain a domestic flag fleet in the lists in the face of competition of this sort, even at the cost of a subsidy, will probably be cheapest in the long run.

Foreign ship subsidies may be injurious to the interests of the country, or they may not. Short-term subsidies are like short-term dumping in their disorganizing influence on an unsupported national shipping industry, and should consequently be resisted. Permanent

## 580 International Trade and Commercial Policy

foreign subsidization of a direct line to a country will not introduce disturbing fluctuations, as will short-term subsidization, and may be accepted as a gift without misgiving. The development of subsidized services between foreign countries may, however, adversely affect the commerce of a given country with third countries, in which case subsidization of services to these third countries might be desirable as a means of maintaining trade with the third countries. The forms of discrimination and unfair competition are manifold, and the proper policy to adopt regarding each can be determined only after careful examination.

In summary, it is doubtful if a national foreign trade fleet contributes substantially to the promotion of a nation's commerce in time of peace. There are, on the contrary, ways in which artificial support of a domestic flag merchant fleet hinders rather than aids the foreign commerce of a nation. As long as a surplus of world tonnage above the requirements exists—and the present inclination of the world's leading maritime nations to support their merchant fleets regardless of the cost gives promise that the period will be long—there is little danger that where commerce exists it will not be served or that discriminatory or exorbitant charges will be levied. It is not easy to say how far government subsidization of counterdevelopment, and retaliation against subsidies of foreign governments and unfair competitive practices of foreign lines are warranted on strictly economic grounds. Subsidies can, however, be justified in certain cases. The operation of a domestic flag merchant fleet may minimize the dislocation of a nation's trade with neutral countries in time of war; to assure the wartime services of national vessels for the nation's needs, however, the lines should be operated under contracts which prevent the withdrawal of ships for service in the more profitable war trade. But whatever benefits may be rendered a country by a foreign trade fleet, the chief claim such a fleet can make for government support must, after all, probably rest upon its value in national defense. The programs of government subsidization of most maritime nations have been built more upon considerations of national pride, honor, and prestige—aroused by the untiring efforts of groups which stand to profit from such a policy—than upon careful calculation of the economic interests of the nation.

## THE SHIPBUILDING INDUSTRY

Shipping costs fall into two categories: (1) direct operating costs, of which the most important are wages and fuel expense, and (2) overhead costs, chiefly interest and depreciation. Overhead costs are determined largely by the prices which must be paid for ships. Thus, it is to the obvious advantage of every shipping line to buy its ships wherever they may be purchased most cheaply. If all nations followed a free-trade policy with reference to ships, the overhead costs of the various national merchant fleets would differ but little. Some differences in overhead costs would, to be sure, remain because of differences in interest rates, and possibly different depreciation policies. But differences in total shipping costs would be attributable primarily to differences in operating costs. Such a policy would bring lower transport costs and would result in a more economical utilization of productive resources.

The shipbuilding industry tends naturally to become localized where the costs of building on an extensive scale are lowest, and this has generally been close to the sources of supply of the most important materials. Shipbuilding materials are bulky, and the costs of transporting them high; with construction close to the sources of materials, these transport charges can be held to a minimum. Such localization tendencies have been modified in part, however, by labor-cost differentials and by differences in the state of shipbuilding technology. The proximity of shipbuilding yards to the centers of the shipping industry has been of little economic importance to the location of shipbuilding yards because ships, once completed, can usually be loaded with a paying cargo and delivered at little or no cost even at great distances.

In the period of wooden sailing vessels, the shipbuilding industry tended to locate in those countries and regions where there were complete supplies of ship timber; the chief factor in the preeminence of the American shipbuilding industry in the decades before the Civil War was an abundance of ship timber close to tidewater. With the development of metal steamships, the industry tended to shift to areas of heavy industry,<sup>10</sup> which in turn tended to concen-

<sup>10</sup> Shipbuilding requires iron and steel plates and angles, pumps, engines, generators, machinery, and other such equipment.



## 582 International Trade and Commercial Policy

trate near supplies of coal and iron ore. Great Britain's dominant position in shipbuilding since the middle of the last century is attributable primarily to her rich deposits of coal situated close to tidewater and easily accessible to a wealth of excellent iron ore. Although the shipbuilding industry in the United States has had the advantages of highly developed heavy industries, it has been handicapped by the high American wage-level. Unlike certain American export industries, the shipbuilding industry has been unable to counterbalance the high wage-level with economies of scale.<sup>11</sup>

But the shipbuilding industry has not been left free to localize in the areas of lowest costs. Many nations have sought to nurture a domestic shipbuilding industry by protecting shipbuilders to whatever extent it has been found necessary. Protection to shipbuilders has assumed one, or both, of two forms: (1) autarchic navigation policies, which stipulate that all national ships be built in domestic shipyards and that all domestic trade and much foreign trade be transported in national ships, and (2) subsidies paid out of public funds. A high degree of autarchy has always prevailed in the navigation policies of the United States, while more recently resort has also been had to construction subsidies. France and Italy have depended chiefly upon bounties, at the same time maintaining a certain amount of free trade in ships. Some of the poorer and smaller nations, such as Norway and Denmark, on the other hand, have preferred to buy vessels in the cheapest market.<sup>12</sup>

Two considerations in particular have emphasized the desirability of a domestic shipbuilding industry: the desire to guard the secrets of the design of naval and auxiliary vessels from the prying eyes of foreign powers, and the urgency of possessing an industry at home capable of stepping up the output of ships in time of war when it is difficult, if not impossible, to purchase ships abroad. The disadvantages of operating high-cost ships produced in domestic shipyards

<sup>11</sup> In 1939, for example, skilled mechanics in the Federal Shipbuilding yard at Kearney, New Jersey, received \$7.64 for an eight-hour day. For similar work in a British yard the pay was \$2.87. The wage differential with other shipbuilding nations, especially Japan, was even greater.

Considerable advances in the art of shipbuilding have been made in the United States in the vast shipbuilding program of the Global War. But it is doubtful if even those advances prove sufficient to offset the disadvantages of the American industry.

<sup>12</sup> Hutchins, *op. cit.*, p. 23.

may be minimized by anticipations that the domestic shipyards, if they can attain a sufficiently large output, can reduce costs to such a degree that they can compete on even terms with foreign yards (our old friend, the infant-industries argument). Artificial stimulation of national shipbuilding industries by the protection accorded shipbuilders who operate inefficiently or are situated in uneconomical locations, however, has materially increased transportation costs and has been a major cause of the excess capacity in world shipping, with its resultant cutthroat competition.

There is a fundamental conflict between the policy of promoting a rational, low-cost, international system of ocean transportation and the policy of developing a number of protected national shipping services in order to increase the security of national sea transportation systems and enhance the naval power of rival nations. The United States Maritime Commission has recognized this basic contradiction between the twin functions of subsidized shipping—that is, trade and defense. Many of the requirements of defense, such as excessive speed and additional bulkheads, may make the costs of vessel operation excessive or reduce the effectiveness of the vessel as a commercial carrier. This contradiction extends to shipbuilding. Considerations of national defense have warped the development of the entire international system.

Since there is every reason to believe that nationalistic considerations will continue to shape the navigation policies of the major nations for years to come, is any compromise possible which will permit the tempering of these autarchic policies with economic considerations? An interesting program for the United States, which incorporates such a compromise, has been suggested by Professor Hutchins.<sup>18</sup> It includes a stable, long-range program of warship construction in domestic public or private yards, or both, the purchase of the larger portion of the merchant fleet abroad, and the construction of such merchant vessels at home as may seem desirable to maintain a shipbuilding industry of such size as is deemed essential for security and defense. Professor Hutchins's program would have the advantage of maintaining a domestic shipbuilding industry of substantial capacity in all kinds of work and of giving promise of utilizing it to capacity, thus minimizing overhead costs, while at the

<sup>18</sup> *Ibid.*, p. 23.

## 584 International Trade and Commercial Policy

same time construction costs would be held down, to the benefit of both ship operations and the American taxpayer. With the excess of world tonnage and the over-expanded shipbuilding facilities which seem certain to appear in the postwar world, however, any shipping program which involves the purchase of any substantial number of ships abroad will have little hope of overcoming the resistance of domestic shipbuilding interests.

### TECHNIQUES OF STATE SUPPORT TO THE MARITIME INDUSTRIES

Once a nation has reached the decision that the improvement of its own transportation services, the promotion of its naval power, or the achievement of economic and political security demands the construction and maintenance of a domestic flag merchant fleet, there still remains the question of the best means of attaining these objectives. Two general courses are open. One is for the government to render whatever assistance is necessary to support a fleet of privately owned and privately operated vessels. The other is to create a government-owned fleet, which may be operated directly by the government or leased by the government to private operators. While government aid to private shipping has been more common, public ownership of shipping has been by no means uncommon.

#### A. STATE AID TO PRIVATE SHIPPING

It has been estimated that more than one hundred techniques have been employed at one time or another by maritime nations to protect and control the national merchant marine. Here, only the most important of those which have been employed in modern times will be examined.

1. *Navigation Monopolies.* Navigation monopolies are designed to protect and encourage national shipping by eliminating foreign vessels from service on chosen routes. Foreign vessels may be kept off the designated routes either directly by prohibition or indirectly by means of discriminatory port dues, duties, or other burdens. Navigation monopolies are most frequently established in the coast-wise and the imperial trades. But they have also been granted in the foreign carrying trades as well. The most famous navigation monopolies were those established by the famous British Navigation

Acts of the seventeenth century, which protected British shipping engaged in the carrying trade of the British Empire until 1849. The United States closed its extensive coastwise trade to foreign ships in 1789 by means of heavy dues; since 1817 foreign shipping has been expressly excluded from the American coastwise trade. In the latter year, the American navigation system was extended by means of certain limitations on the employment of foreign ships in certain branches of the foreign carrying trade, but these were later abolished. The monopoly of the American coastwise trade has since been extended to the trade with Alaska, Hawaii, and Puerto Rico and to the intercoastal traffic. Coastwise and imperial monopolies were, in the decade before the Global War, part of the systems of Germany, France, Italy, Japan, Spain, Australia, Canada, Brazil, Chile, and other states.

By forcing foreign vessels off the protected routes or by causing a rise in the costs of operating foreign vessels through the imposition of discriminatory dues or duties, rates on these routes will be increased, and it is to be expected that the increase in rates will secure an expansion in the tonnage of domestic flag shipping.<sup>14</sup> The exclusion of foreign ships will permit rates to rise to the level of operating costs of domestic ships; and, if competition is thereafter maintained, rates should oscillate about this level of costs. However, if a single shipping line can gain a monopoly of any given route, or if a ring is formed, rates higher than this cost level can be established. In either case, the cost of protection is paid by the shippers and is usually passed on to consumers in the form of higher prices. If the costs of national shipping are considerably in excess of those of foreign shipping, and if no significant economies of large-scale operations result, the rise in transportation costs may be great. On the other hand, if the cost differential is small, and if economies of scale develop in both shipping and shipbuilding, rates may rise little, if at all.

The extent of the expansion of the domestic flag fleet will depend largely upon the elasticity of demand for tonnage on the protected routes. If the demand is very elastic, a serious shrinkage in traffic will occur and the enlargement of the national shipping industry will be slight. If the demand is inelastic, the shrinkage in traffic will be

<sup>14</sup> Cf. *ibid.*, pp. 42-43. For the material in this section I am indebted to Professor Hutchins.

## 586 International Trade and Commercial Policy

small and a sizable expansion of the national fleet will follow. The elasticity of demand for tonnage, in turn, rests largely upon three factors: the ratio of freight charges to the selling prices of the goods transported, the availability of alternative routes or transportation agencies, and the mobility of the industries concerned. Elasticity will be high where freight charges bear a high ratio to the selling prices of the goods transported. It will also be high where there is effective competition from other routes and agencies. For example, the development of transcontinental railroad systems in the last half of the nineteenth century greatly reduced the protective value of the American policy of coastwise shipping. The elasticity of demand for tonnage will also be high if it is possible to avoid the increased rates by rerouting shipments by way of third countries, if industry can be easily relocated, or if the traffic cannot bear the cost.

A policy of establishing navigation monopolies may be highly successful in maintaining large shipping and shipbuilding industries without the payment of subsidies, although it should be remembered that the chances are great that navigation monopolies will mean an added burden to shippers and consumers. In fact, such a policy may be the simplest and most effective means of nurturing a domestic flag merchant fleet if retaliation can be avoided.<sup>15</sup> It is obviously more suitable for routes on which competition is active than for those which have come under the dominance of monopolies. On the other hand, it makes orderly routing of ships impossible and thus causes much waste motion. There also seems little doubt that it has resulted in higher transportation rates and that these have tended to restrict commerce.

Because the navigation monopoly is a clumsy method of stimulating shipping and shipbuilding, and because it creates grave inefficiency and obstructs the development of a rational transportation system, there has been a tendency to abandon it. Great Britain and Holland have gone far since the middle of the last century toward opening their imperial trade to the ships of all nations. The United

<sup>15</sup> Retaliation against a monopoly of the coastwise trade is difficult, except by shutting the shipping of the protecting nation out of similar carrying trades abroad; and, where this shipping activity is of small extent, the counter measures will be of slight importance. Navigation monopolies of the coastwise trade may protect shipping engaged in the foreign carrying trades as well by providing protection on important legs of multi-angular voyages.

States, France, and Spain, however, have adhered to relatively restrictive policies.

2. *Subsidies.* The principal alternative to the navigation monopoly as an instrument for promoting a domestic flag merchant marine is the subsidy, or bounty. The subsidy may be briefly described as a special financial grant by a government for the support of shipping. The subsidy is designed to make it possible for ship operators to set rates below their full costs of production so that they may compete on even terms with foreign operators, or even drive foreign shipping from certain routes. Subsidies usually result in lower freight rates to shippers and somewhat lower prices to consumers; but, since they are paid out of the public treasury, the burden is merely passed on to the taxpayers. While shipping subsidies have been employed since early times, they are today the major device of navigation policy.

Shipping subsidies have the advantage over the navigation monopoly in that they enable the state to exercise wide control over the size and design of vessels, speed, routes, and the frequency of service. Retaliation in kind is more difficult and is less likely to be encountered in the case of subsidies, for many states are reluctant to make financial grants to private operators and prefer to accept the services of subsidized foreign shipping lines which call at their ports. On routes where the use of other techniques is undesirable, because, for example, of the existence of reciprocal treaties designed to secure free navigation, subsidies are the most effective means of supporting national shipping. The growth of a subsidized merchant fleet may also bring economies of large-scale operation.

(a) **THE CONTRACT SUBSIDY.** Shipping subsidies fall into two main categories, the contract subsidy and the general navigation bounty. The contract subsidy is an arrangement to promote shipping services on a particular route. In return for a grant of a fixed sum per year, the contractor usually agrees to provide a regular service consisting of a certain number of trips annually on a specified route in ships of a given speed, size, and other characteristics, such as suitability for naval or military service. Frequently, it is stipulated that the ships shall be available to the government in time of war on certain terms. The mail subsidy is of this general category. It provides for payment for the carrying of mails on domestically-owned

## 588 International Trade and Commercial Policy

ships, on the basis of either distance traveled or poundage, at rates higher than those paid to foreign-owned ships.

Contract subsidies ordinarily result in the creation of large enterprises acting as contractors to the state. Since it rarely pays to subsidize more than one operator on a single route, and since unsubsidized lines and ships are likely to be forced off routes plied by subsidized lines, a mutual interdependence ordinarily develops between the state and the contractor: service on each route is obtainable only from the contractor, and the contractor's ability to continue the service rests upon the continuance of the subsidy. The expulsion of unsubsidized shipping from the subsidized routes increases the supply of tonnage on other routes and tends to depress freight rates on the latter.

The government subsidy in some instances merely compensates for the additional expenses incurred by the provision of extra speed, regularity of service, extra bulkheads, and other military features of the ships, and by the special liability for military service in time of war. Subsidies of this type are likely to add little cargo capacity to the national fleet.

Determination of the proper size of subsidies has been difficult. The usual method has been to call for bids for a specified service, and the award is made to the lowest bidder. But it has been difficult in initiating a service to secure informed and responsible bidders. Serious errors in estimating the costs of vessels, the expenses of maintaining the service, and the volume of traffic have resulted in the financial failure of the contractor and the disorganization of the service, or in undue profits and public criticism. Nor has competitive bidding at the time of renewal been satisfactory. Competent bidders have been reluctant to risk competition with established lines, and, where competitors have entered the bidding, existing contractors have frequently cut their bids too low, and have thus made inadequate service, or failure, inevitable. Since shipowners must obligate themselves to provide a given service over a period of years regardless of changes in costs, demand, and foreign navigation policies, and, since no contractor can correctly gauge these changes years in advance, the only satisfactory policy is one which allows flexibility in the terms and amounts of the contract to meet these economic and political changes and assures a sufficient degree of permanency

in the relationship to attract private capital. Sudden cancellation of contracts, except for failure to perform, inefficiency, or fraud, are extremely disturbing. Only the public interest justifies contract subsidies. But where it does, contractors should be assured of adequate resources at all times, while at the same time they should not be permitted excessive earnings. "Long experience has clearly shown that the mere grant of money, followed by a policy of laissez-faire, is most unsatisfactory."<sup>16</sup>

(b) THE GENERAL NAVIGATION BOUNTY. The general navigation bounty differs from the contract subsidy in two respects. First, it is given on a mileage and tonnage basis to *all* owners whose vessels qualify. Second, the subsidized ships are left free to roam the seas as their owners desire, since no fixed routes or special services are established. By setting different rates for the various types of ships, the construction of desired types of vessels can be stimulated, although requirements relating to speed, compartmentalization, and other military matters are ordinarily of minor importance. Unlike the contract subsidy, which is designed to provide regular and improved services on specified major transportation routes, the general navigation bounty is contrived to increase the size of the entire national merchant fleet without regard to its employment. The general navigation bounty has been used by the United States only to assist fishing vessels, but it has been used extensively by France and Italy since the last quarter of the nineteenth century and by Great Britain more recently to encourage tramp shipping.

Since the general bounty permits the subsidized firms to employ their vessels on whatever routes they choose, vigorous competition on all routes tends to prevail, especially if the subsidized ships are tramps or low-grade cargo vessels, so that profits are held to a competitive level. The system is consequently a relatively economical and effective means of encouraging enlargement of the national shipping industry. Where the unfavorable differential in ship operating costs is great, however, this system may necessitate enormous payments from the public treasury because of the large number of eligible ships. In order to limit bounty payments to a small number of ships, therefore, the contract subsidy is often preferred.

<sup>16</sup> John C. B. Hutchins, *The American Maritime Industries and Public Policy, 1789-1914*, Harvard University Press, 1941, p. 55.



## 590 International Trade and Commercial Policy

3. *Registry Laws.* Registry laws protect the domestic shipbuilding industry rather than the domestic shipping industry. They determine the sources of supply of the ships which may sail under the national flag by placing restrictions on the purchase of foreign-built ships. Registry laws of the United States, for example, require American shipowners operating in the restricted coastwise trade to use only American-built vessels, and, until 1912, imposed the same requirements on American operators in the foreign carrying trades. Nearly all of the ships employed in the subsidized services established under recent American laws have had to be of American construction, with the result that comparatively few ships of foreign construction have been used here by United States shipping firms since 1912.

Where a nation has an unfavorable differential in shipbuilding costs, protective registry laws increase the costs of ship operation. These high overhead costs tend to counterbalance a competitive advantage which domestic shipowners would otherwise possess, or to increase a disadvantage. Such higher costs hamper the development of shipping in the coastwise trade since coastwise shipping must compete with overland transportation; and they tend to force domestic flag ships out of the foreign carrying trades unless ample subsidies are granted or protection is provided. In the latter half of the nineteenth century when foreign nations were building large numbers of iron and steel steamships, registry laws compelled American ship operators to rely on relatively cheap but inefficient wooden ships operated on routes on which metal steamships predominated. Much American capital and enterprise that was available for the support of an American fleet was diverted to financing and managing foreign-flag ships.

A domestic shipbuilding industry is not essential to the maintenance of a national shipping industry. But, if national policy demands a domestic shipbuilding industry, shipbuilding subsidies are a more efficient and wholesome means of encouraging it than registry laws.

4. *Shipbuilding Subsidies.* Like registry laws, shipbuilding subsidies operate to promote the domestic shipbuilding industry rather than the shipping industry. They consist of governmental financial grants sufficiently large to enable the relatively high-cost domestic

shipbuilding industry to sell ships to domestic ship operators at prices no higher than the latter would have to pay to the lower-cost foreign builders. The subsidy plus the price paid domestic shipbuilders, in other words, should just equal the full production costs. Shipbuilding subsidies may be in the form of either a general bounty available to all builders and based on tonnage or a special subsidy for the construction of special vessels. The United States Merchant Marine Act of 1936 adopted the latter form. Subsidization of shipbuilders has the advantage of protecting and encouraging domestic shipbuilding without at the same time penalizing domestic flag shipping.

The bounty should at least equal the differential between domestic and foreign costs of construction in order to assure the existence of domestic shipbuilding where no registry laws exist. But, unless it is desired to bestow on shipbuilders abnormally high profits or to make the shipbuilding subsidy a shipping subsidy as well, the bounty should not exceed this differential. In practice it is extremely difficult to compute this differential, for ship prices vary from time to time, depending on the amount of business on hand in the shipyards, and ships are not standardized. In addition, it is difficult to determine which of the many foreign shipbuilding nations shall be taken as the standard of comparison. Unless domestic shipowners are free to buy ships abroad, the figure which pretends to measure this differential is likely to be arbitrary.

5. *Procurement of Capital.* A century ago, when the shipping industry was dominated by small-scale enterprises, and competition and laissez-faire ruled, capital flowed freely into the industry and came almost exclusively from private sources. With the development of gigantic shipping lines during the past several decades and the consequent weakening of competitive forces, the industry has found it more difficult to attract private capital, not only in nations in which the industry operates at a competitive disadvantage but also in those nations in which conditions are relatively favorable.<sup>17</sup> Two factors have made the shipping industry a comparatively unattractive field for private investment. First, larger and larger subsidies and other measures of state aid have reduced to low levels the returns to unsupported shipping. Second, with the shipping indus-

<sup>17</sup> *Ibid.*, pp. 60-62.

## 592 International Trade and Commercial Policy

try more and more dependent upon public largesse, the inflexibility of contracts and the political uncertainties surrounding the continuity of policies have enhanced the risks of the industry. The difficulties of securing adequate supplies of private capital have forced governments seeking to promote a national shipping industry to adopt positive measures to provide the necessary capital.

These measures have consisted of direct state loans to shipowners or of state guarantees of low-interest loans by private investors. Since the initial investment in a modern, ocean-going, steel steamship of, say, 10,000 tons is large, the reduction of the interest rate on this investment from 6 to 3 per cent means a significant reduction in the total operating costs of ship operators. Competition in reducing capital charges has therefore become sharp. In the United States, loans to shipowners have been made at rates as low as one-eighth of one per cent per annum, while government construction loans of as high as 75 per cent of the cost of new ships have been advanced. The governments of Great Britain, France, Italy, and the Netherlands have all made loans and guarantees to the industry. There has thus been a marked tendency for the equity of the state in the shipping industry to increase and for that of private owners to decrease.

6. *Miscellaneous.* In addition to the above five major devices employed by governments to promote the development of the national maritime industries, there are many other such devices of relatively secondary importance. Measures which affect the cost and quality of services include the exemption of shipbuilding materials from import duties, the insurance of ships by the state at low rates, the sale of government-owned reserve ships at prices far below cost less depreciation and obsolescence, favorable railway rates on shipbuilding materials, and the training at public expense of officers and men ashore and afloat. Measures which affect the volume of goods transported on domestic flag ships are preferential railway rates or lower import duties on goods carried on domestic flag ships, regulations requiring the patronage of national vessels by the state whenever possible, and the coercion of shippers.

Not all government legislation affecting shipping is designed to augment the competitive power of the national merchant marine. The growing concern of the state, over the past 50 years, for the health, safety, and welfare of its citizens—reflected in factory legis-

lation and legislation to protect consumers—has also been reflected in legislation affecting shipping. Instead of subsidizing shipping, many of these regulatory laws tend to increase the costs of shipping operations. Included in such regulation are laws governing wage rates, manning scales, passenger accommodations, load lines, the safety features of ships, labor conditions in shipping, and the professional competence of officers and men.

#### B. GOVERNMENT OWNERSHIP OF SHIPPING

Private ownership and operation has for centuries been the accepted type of organization for the bulk of the world's shipping. But the progress of technology during the past century, which has changed the shipping industry from one of innumerable small enterprises to one of few vast enterprises, and the adoption by most maritime nations of strong nationalistic navigation policies have made it practically impossible for private enterprise unassisted to render those shipping services which modern nations deem essential to their national security and prestige. The attitude that shipping is a service in the national interest, the growing difficulty of operating private shipping, and the increasing financial stake of government in national shipping enterprise—the result of government subsidy and loan policies—combine to favor public ownership of shipping. Before 1939, government ownership and operation of shipping had been resorted to by Germany, France, Italy, Russia, Canada, and Brazil, to a greater or lesser extent; and in both World Wars, the United States government was forced to build and operate ships in order to secure the shipping services necessitated by wartime demands.

Government ownership of shipping has usually developed out of one of four different situations.<sup>18</sup> First, private contractors have been unable, or unwilling, to provide certain services desired by governments. Second, the difficulty of disposing of government-owned tonnage acquired in time of war has compelled governments to establish government-operated lines in order to secure some return on their heavy investment in ships. The seven United States Government lines which were in operation on June 30, 1937, came into being for this reason. Third, where inefficiencies or scandals have de-

<sup>18</sup> *Ibid.*, pp. 62-63.

## 594 International Trade and Commercial Policy

veloped in subsidized private lines, or where private lines have faced financial failure, governments have been forced to buy the ships or to invest in the common stocks of shipping companies and appoint the principal officers in order to protect their own interest and the national shipping services. Fourth, government ownership of shipping has developed as a result either of political philosophy, as in Soviet Russia, or of special circumstances, as when the United States by acquisition of the Canal Zone also acquired the ships of the Panama Railroad.

The debate over the respective merits and demerits of private and government ownership has been long and heated. Proponents of government ownership have declared that the subsidy system is wrong in principle and has failed in practice, that the service objectives of shipping could be better achieved by a nationalized fleet, and that government operation would facilitate standardization, increase safety, solve the labor problem, insure needed replacements, strengthen a nation's competitive position with regard to the nationalized fleets of other nations. One writer has indicted the policy of subsidizing private shipping in the following words: "The experience of the United States since the World War . . . indicates that the profit motive may cause contractors to lobby extensively, syphon off funds, pad accounts, bribe officials, and generally waste government money, especially if they are extremely dependent on the subsidy and have little equity."<sup>10</sup> Opponents of government ownership and operation have declared, on the other hand, that the government cannot get good men, solicit business, nor operate as efficiently as private enterprise, and that the government is susceptible to political pressure, and may lack initiative.

Whether a nation should rely upon subsidized private shipping or should own and operate its shipping through its government will depend in the last resort upon which method promises to assure its objectives most effectively and most economically. American experience with government ownership and operation during and after World War I is frequently offered as evidence of the ineptness of this method. But, as one student has observed:

The costly Shipping Board construction and operating programs did not demonstrate the inefficiency of Government enterprise because, with

<sup>10</sup> *Ibid.*, p. 63.

rare exceptions, the Government had little to do with them apart from bearing their cost. The ships were built by private companies—not by the Government; they were operated by private managing operators—not by the Government; they were laid up and taken out of service primarily at the instigation of private operators; finally, they were sold at a fraction of their true value as a result of pressure exerted by private companies. The Shipping Board program did not demonstrate the failure of Government enterprise, but it did prove that when the shipping interests are forced to choose between private profit and the public interest, they invariably place private gain before public advantage.<sup>20</sup>

The Maritime Commission has pointed out that, although American Government lines have been maintained at a net loss, their record compares not unfavorably with that of certain of the subsidized lines.<sup>21</sup>

The American people have been traditionally opposed to the entry of government into business, and the Merchant Marine Act of 1936 seeks to preserve private operation of shipping "insofar as may be practicable." But, with the present world-wide trend toward government ownership, and either government or private operation, the continuance of private ownership of shipping in the United States may depend upon the efficiency of private administration, and the ability of private lines to finance replacements. It is significant that, outside of Russia, public ownership of merchant tonnage is most advanced in those countries where conditions for operation are most unfavorable, and where large public grants have been made.

#### AMERICAN MERCHANT MARINE POLICY

*Before the Civil War.* The history of the American merchant marine down to the eve of the Civil War was one of continuous development. Shipping and shipbuilding were important industries in New England even in colonial times, and by the end of the seventeenth century more than one thousand vessels had been built in the area. New England's preeminence in the maritime industries in this era rested upon two major factors. First, the lumber from which fine wooden ships could be fashioned was obtainable in abundance in

<sup>20</sup> Paul M. Zeis, *American Shipping Policy*, Princeton University Press, 1938, p. 210.

<sup>21</sup> *Economic Survey of the American Merchant Marine*, pp. 27-34.

## 596 International Trade and Commercial Policy

forests that grew almost to the water's edge. Second, the scarcity of good agricultural land turned the inhabitants to other pursuits which offered a greater return to labor—shipping, fishing, whaling, and shipbuilding. By the time of the Revolution, more people in northern New England were engaged in navigation and shipbuilding than in agriculture. The maritime industries were also favored by the dependence of the early settlers upon water transportation, for many localities had no other means of communication with the outside world, and by the skill in shipbuilding which many of the newcomers from England and elsewhere brought with them.

During the Revolution, the British Navy seized or sank nine hundred American vessels and virtually drove American commerce from the high seas. The weak American government, under the Articles of Confederation, had no effective power over commerce and no means of offering aid to the industry, which had failed to regain its prewar robustness—primarily because of the discriminatory navigation laws of France and England. With the reorganization of the government in 1789, Congress came to the aid of the maritime industries. The shipbuilding industry was protected by a law which provided that only ships which were built in the United States and belonged to citizens thereof would be privileged to register under the American flag. The shipping industry was aided by laws which provided for a reduction of 10 per cent in import duties on goods imported in American ships and imposed discriminatory tonnage taxes on foreign vessels using American ports. The effects of these laws was immediate. American tonnage in foreign trade increased from 123,893 in 1789 to 400,000 in 1792, and by 1794, 91 per cent of American imports and 86 per cent of American exports were carried in American ships.

The outbreak of the Napoleonic wars in Europe in 1792 gave a further fillip to American shipping: American tonnage in foreign trade increased to 630,000 in 1801 and to 800,000 in 1806. Severe losses to the shipping of the two belligerents widened the opportunities of neutral shipping, with the result that by 1810 American tonnage in foreign trade had increased to 981,000, despite the British and French blockades, and President Jefferson's embargo and non-intercourse acts. But again the British Navy virtually obliterated

the American merchant fleet when the United States permitted herself to be drawn into the war.

The American shipbuilding industry did not need the protection afforded it by the registry law of 1789; its comparative advantage enabled it to hold its own in fair competition against any shipbuilding in the world. Consequently, this law during the era of wooden ships worked no hardship on American shippers in compelling them to buy American-built ships if they intended to enter the carrying trade under the American flag.

Realizing that the United States could become the leading carrier in the world, given a fair field without discrimination or restriction, the government concentrated its energies after 1815 on the promotion of fair international competition in shipping and on securing, if possible, free navigation. In 1817, a Navigation Act was passed which forbade the importation of goods from any foreign country except in American vessels or vessels of the country from which the goods came, but at the same time exempted from the provisions of the Act the ships of countries which imposed no discrimination against United States vessels. Another section of the same law provided for the complete exclusion of foreign vessels from the coastal trade. In 1828, the United States offered to repeal discriminating taxes and duties on ships of nations which accorded us the same privileges, and in 1830 repealed the tonnage taxes on American vessels and made the same concession on the vessels of foreign nations which extended similar concessions to American vessels. Gradually these American attempts to secure reciprocity bore fruit, and reciprocity became the order of the day.

From 1815 to 1858 the American merchant marine expanded steadily, and after 1840 experienced great prosperity even though the discriminating duties had been repealed. American tonnage in foreign trade reached 2,348,000 in 1855. To an increasing extent, crews were recruited from the English, Irish, and Scandinavians, under the supervision of American officers, as New Englanders began to turn to manufacturing and the internal development of the country. A brief experiment with mail subsidies in 1847, when an attempt was made to compete with the newly established British steam packet boats and to facilitate the shipment of mail and troops



## 598 International Trade and Commercial Policy

on the Atlantic and Pacific coasts, proved a failure and was discontinued in 1858.

During the pre-Civil War period, the great bulk of American shipping was in the form of fast-sailing packets or clipper ships, in the design and construction of which American shipyards were unequalled. But in 1858 the period of natural American shipping supremacy was drawing to a close: the iron ship was already beginning to displace its wooden rival. What might have been a process of gradual decay of the American merchant marine was turned into a speedy decline by the Civil War. Fear of Confederate armed cruisers and heavy war taxes induced many northern shipowners to sell to foreigners 750,000 tons of shipping—about one-third of our foreign trade fleet—while others, fearing to operate their ships, laid them up in port. Confederate raiders destroyed about 110,000 tons more, so that by 1866 only about 25 per cent of American foreign trade was being carried in American bottoms. Furthermore, the stimulus of the neutral trade gave an extra impetus to the growing English iron shipbuilding industry and to foreign shipping—a competition which American wooden ships never again succeeded in matching.

*From the Civil War to World War I.* Protection to the shipbuilding industry in the pre-Civil War decades had in no way handicapped American shipping, because American shipbuilders could build wooden ships as cheaply as could shipbuilders in any other country. But, in the decades following the war, American registry laws and the failure of the government to adopt a proper subsidy policy led to an attrition of the American foreign trade fleet until by 1910 tonnage had dropped to 792,000, and only 8.7 per cent of American foreign commerce was carried in American ships. At a time when the wooden ship had been superseded by the iron, and later the steel, steamship the United States had no well developed iron and steel industry, whereas England did, and could build iron ships at much lower costs than the United States. Since all ships of American registry had to be American-built, the high costs of ships put American operators at a serious competitive disadvantage.

This natural disadvantage was further increased by high import duties on iron and steel, and later by monopolistic controls in the

steel industry that kept American iron and steel prices well above British. At the same time, capital and labor in the United States were attracted by the more tempting profits to be realized in western railroad construction, manufacturing, city expansion, and western farms. Another serious blow to the merchant marine was a law which provided that no American vessel that had been transferred to foreign registry during the Civil War could be readmitted to American registry. Thus, at one stroke, 750,000 tons of shipping were denied American registry.

The tendency up to the first World War was to accept in most branches of American foreign trade low-cost foreign shipping services and the benefits of foreign bounties. The failure to develop a healthy American merchant marine in this period was due principally to the ill-conceived and contradictory policy which made the costs of American ships high and failed to give the shipping industry the assistance necessary to overcome this initial cost disadvantage and to offset foreign bounties. To secure surplus capacity for the building of warships in time of war, foreign-built ships were excluded from American registry. But the cost of American-built ships was kept high by the protection granted the steel industry, and later by the formation of the steel trust. While the operating costs of American ships were probably higher than those of their chief foreign competitors, because American shipowners were compelled to employ higher-salaried officers,<sup>22</sup> the operating differential was small in comparison with the fixed-charges differential.

The handicap of the fixed-charges differential could have been removed by permitting shipowners to buy ships in the lowest-cost market, or by paying them a sufficient bounty. The strength of protectionist sentiment, however, prevented the adoption of a free ship policy, while any political agreement on a satisfactory system of subsidies proved impossible, although two different experiments with subsidies were tried. Mail subsidies to Brazil and Far Eastern lines in 1865 were abandoned in 1875 in the wake of disappointing results and a Congressional investigation that threw the whole subsidy system into disrepute. A subsidy law in 1891 failed to bring any substantial expansion of our export trade and proved deficient in

<sup>22</sup> For a more complete discussion of American shipping costs, see Zeis, *op. cit.*, pp. 41-48.

## 600 International Trade and Commercial Policy

strengthening our national defenses. The strong position of foreign contract services and conference lines, and the lack of confidence in the stability of American policies, furthermore, tended to discourage the rise of new American operators. Not until 1909 was the suggestion introduced in Congress that the government should build and operate our merchant ships. Yet by 1918, the complete failure of the pre-1914 policy together with the demands of war had resulted in making the United States government the largest shipowner in the world.

The only feature of American policy which justified itself during this era was the reservation of the coastwise trade—including that to the island possessions—for American ships. The maintenance of this monopoly did more to build up and maintain an American merchant fleet than all the subsidy and discriminatory legislation passed from the Civil War up to 1914. In 1910 the coastal fleet totaled 6,668,966 tons, in contrast to a foreign trade fleet of a mere 782,517 tons. At the outbreak of the first World War, nearly 90 per cent of the merchant marine operated under the protection afforded the coastwise trade.

*Since the First World War.* The sharp upsurge in shipping rates which followed the outbreak of war in 1914 and which resulted from the withdrawal of German tonnage from world trade routes, the decimation of Allied shipping by German submarines, and the distortion of trade currents, with the consequent necessity for longer hauls, brought forth from exporters the cry for more domestically owned ships and led to the passage of the Merchant Marine Act of 1916. This Act provided for the establishment of a shipping Board which was to have important regulatory powers over shipping and was also to create and control an Emergency Fleet Corporation. The latter, in turn, had charge of the construction of an enormous fleet of government vessels. The Board's original capital of 50 million dollars was raised the next year to 750 million dollars but by June 30, 1921, the Board had spent \$3,316,000,000 to construct an armada of some 2500 ships. Some of these vessels were as much as five years old in design when completed; many were structurally unfit for any sustained service; and most were built to meet the war emergency in the quickest way possible without regard to the character or volume of tonnage which an evolutionary expansion of American flag

service might require. Some, fortunately, proved to be reasonably efficient on certain routes.

American shipping policy after 1919 had a twofold objective: to liquidate this government-owned fleet, and to develop and maintain American flag services on routes important in American foreign trade. While government operation of shipping was not ruled out as a means of promoting American foreign commerce and strengthening our national defense, it was hoped to find employment for the fleet built during the war and, at the same time, to develop operations to the point where they would be attractive enough to private operators to allow the government to withdraw completely. In pursuit of these objectives, the Merchant Marine Act of 1920 provided for the sale of government vessels at greatly reduced prices in return for the engagement of purchasers to operate them on routes considered essential to the nation's commerce. The fleet of vessels which later operated under mail contracts after passage of the subsidy act of 1928 and cost \$516,174,249.48 to construct was sold for only \$41,411,665.10—less than one-tenth of its original cost.<sup>23</sup> During 1924 the Shipping Board sold to the Dollar Line for \$3,850,000 seven of the "President" type ships which had cost \$29,071,823 to construct.<sup>24</sup>

The Act further conferred upon the Board the power to maintain existing trade routes and to establish new ones which it might think desirable. It authorized the Board to operate vessels itself, where necessary to develop such routes, or to charter them to private operators. Actually, vessels were chartered to managing operators under contracts which paid the operators a certain percentage of the gross receipts and certain commissions as well—a system which resulted in generous profits to the operators but furnished no incentive to keep them from incurring losses. As a further concession to private shipping interests, the Board adopted a policy of deliberately withdrawing the government ships from service and of selling many of the cargo vessels for scrap, at about \$8 a ton, to make certain that they in no way competed with private enterprise. A construction loan fund of up to 125 million dollars furthermore, was set up from which loans could be made to private operators for the

<sup>23</sup> *Ibid.*, p. 135.

<sup>24</sup> *Ibid.*, p. 136.

## 602 International Trade and Commercial Policy

purpose of building new ships. Finally, the Postmaster General was authorized to make contracts, without asking for competitive bids, for the carriage of ocean mail at a compensation enough above transportation costs to enable and induce American shipping companies to add new ships to their fleets, to recondition vessels, and in general to improve their facilities and services. But limited appropriations for foreign mail service at the time had the effect of confining this activity within rather narrow limits.

The failure of the Shipping Board and private interests to build up and maintain a stable and profitable American merchant marine under the Act of 1920 led to new legislation in 1928—the Jones-White Act. This Act increased the size of the Construction Loan Fund to 250 million dollars and provided that shipbuilders might borrow at low rates of interest as much as 75 per cent of the construction cost; the loan was to be paid off over a period of 20 years. Ships constructed with the aid of this fund were required to remain under American registry until the loan was completely repaid. The differential between the interest actually paid on CLF loans and the sums which would have been paid at commercial rates of 5 per cent was estimated at 45 million dollars up to 1936. Provisions were also made for mail contracts of a highly lucrative character. Up to 1936, mail payments under the Act aggregated 176 million dollars. One American steamship company was revealed to have received in 1932 an average of \$66,000 for each pound of mail it transported!

But the Act of 1928 was not much more successful in giving the United States a modern and efficient merchant fleet than that of 1920. Although one of the chief objectives of the Act was to provide for a program of new construction to replace the Shipping Board fleet, which was rapidly becoming obsolete, the program of new construction materialized in a most meager fashion, despite a very liberal administration of the Construction Loan Fund by the Shipping Board. On May 31, 1937, the American dry cargo, foreign trade fleet consisted of only 385 vessels totaling 2,529,000 gross tons. Of that fleet, 339 vessels, with an aggregate tonnage of 2,093,000, would have become obsolescent by 1942. The weak position of the United States among the six principal maritime nations on May 31, 1937, is illustrated in Table 10, which shows that we ranked fourth in gross tonnage and fifth in ships having speeds of 12 knots and over. Our

actual position in vessels 10 years of age and under was eighth, rather than sixth as Table 10 indicates, because both the Netherlands and Norway, neither of which is included in the table, had more ships 10 years of age and under than the United States.

**TABLE 9. Foreign-Trade Fleets of the Six Leading Shipping Countries on May 31, 1937**

Amount of Tonnage		Vessels with Speeds of 12 Knots and Over		Vessels of 10 Years of Age and Less	
Country	Gross Tons	Country	Gross Tons	Country	Gross Tons
Great Britain	13,100,000	Great Britain	8,278,000	Great Britain	4,689,000
Japan	3,059,000	Germany	2,015,000	Germany	1,020,000
Germany	2,813,000	Japan	1,614,000	Japan	774,000
United States	2,529,000	France	1,521,000	France	528,000
Italy	2,283,000	United States	1,363,000	Italy	418,000
France	2,177,000	Italy	1,242,000	United States	416,000

Source: United States Maritime Commission, *Economic Survey of the American Merchant Marine* p. 39.

The weakness of the Acts of 1920 and 1928 lay not only in the Acts themselves but also in their administration. Subsidies were, in practice, granted at the maximum allowable rates to almost all contractors and were thus in no way accommodated to the varying cost handicaps and conditions found in different services. In many instances, inadequate replacement requirements were incorporated in the mail contracts at the insistence of influential contractors. Subsidy funds which should have built vessels or created reserves were diverted to innumerable other purposes: high salaries, exorbitant expenses, and fat profits and dividends. One other fatal consequence was the failure to maintain a marine personnel of ability, loyalty, and reasonable contentment. Responsibility for these abuses lay in part with private shipping interests and government officials who opened the gates to the subsidy treasury.

The Merchant Marine Act of 1936 was passed to remedy the defects of the earlier acts. The Act of 1936 abandons ocean mail subsidies and substitutes therefor direct subsidies to meet the difference between foreign and American costs of constructing and operating vessels. The construction subsidy seeks to secure the replacement,

## 604 International Trade and Commercial Policy

year by year, of obsolete vessels of the merchant marine with new and better ones constructed in American shipyards. The size of the construction subsidy in any particular case is determined by three factors: (1) the cost differentials between shipbuilding in the United States and in some selected foreign shipbuilding center; (2) the amount of grants given by foreign governments in the building of ships which will be competitors; and (3) additional costs for features which are necessary for ships intended to serve as naval or military auxiliaries during war but are unnecessary for the peacetime carrying trade—for example, increased speed, greater cruising radius, deck space for airplanes, extra bulkheads, etc. The total construction subsidy must not exceed 33½ per cent of the American cost, although in special circumstances it may rise to 50 per cent.

The need of a new ship on a designated route, and the design, must be approved by the Maritime Commission before the ship becomes eligible for the subsidy. Construction bids are solicited from private shipbuilders and, if one of these is considered satisfactory, a contract is made with the shipyard. If no satisfactory bid is forthcoming, the Commission may order construction in a United States navy yard. The purchasing ship operator pays only what it would cost to construct the ship in some foreign center, and the government pays the difference between the foreign cost and the domestic price. The operator is required to make a down payment of 25 per cent of the total American cost and to pay the remainder of his contract price in 20 equal annual installments, with interest at 3½ per cent. Until the ship is paid for in full, it must be operated under United States registry. A shipbuilder's profits from construction work done for the Maritime Commission shall not exceed 10 per cent; any excess above that figure must be credited to the government. And in calculating costs and profits, no salary of more than \$25,000 a year to any individual can be allocated as an item in construction costs.

While the extent of the subsidy necessary to compensate for special features on a ship can be determined with some accuracy, the estimation of the part of the subsidy that is to cover the differential construction costs presents greater difficulties. The Commission admits that it has encountered considerable trouble in obtaining reliable and adequate cost data in foreign shipbuilding centers. And,

too, plans and specifications of ships differ greatly so that a direct comparison is rarely obtainable. Furthermore, costs of construction differ considerably between different foreign centers. Which country is to be taken as the standard of comparison? Fluctuating rates of exchange and the use of several different exchange rates by a single country also add to the complexities of cost comparisons. Finally, foreign subsidies are difficult to estimate, for the extent of the aid is frequently modified from year to year, and in many instances it is kept secret.<sup>25</sup>

American shipping companies performing, or proposing to render, an essential service over an ocean route which is important in the foreign commerce of the United States are to be paid by the Maritime Commission an operating subsidy equal to the difference between the costs of operation under the American flag and the costs of competitors operating under foreign flags. This provision recognizes the disadvantages under which American ships operate with respect to wages, the size of crew considered necessary by the Commission, passenger subsistence, repairs, and foreign operating subsidies. Subsidies cannot be paid for the operation of wooden or sailing ships, vessels not built in the United States, or vessels over twenty years old. During the life of the subsidy the ships must be operated under United States documentation. The operating contract and subsidy agreement may run for a period not to exceed 20 years, and the compensation paid may be reduced for periods when vessels are laid up. If at the end of a five-year period the shipping company's cumulative profits, after setting aside a depreciation reserve fund and a special reserve fund, are found to have exceeded 10 per cent, one-half of the excess above 10 per cent is to be paid to the Commission. No official of a subsidized company is to receive a salary in excess of \$25,000 a year.

The Act creates a Maritime Commission of five members, to which is assigned all of the duties and powers vested in the Shipping Board

<sup>25</sup> The Netherlands was chosen as the principal foreign shipbuilding center for estimating the cost differential upon which the subsidy for the first ship constructed under the Act was to be based. The cost of the American vessel was estimated at \$15,750,000 as compared to the foreign cost of \$10,500,000, thus making the amount of the subsidy \$5,250,000. For a more complete discussion of the obstacles to calculating these differentials, see *Economic Survey of the American Merchant Marine*, pp. 70-75.



## 606 International Trade and Commercial Policy

by extant portions of the Acts of 1916, 1920, 1928, and 1933, and grants it additional powers. This body functions as (1) a policy-making and promotional organization, (2) a regulatory arm of the Federal government, (3) a government-owned shipping concern, and (4) the sole agency for the determination, payment, and supervision of shipping and shipbuilding subsidies.

The Commission began in 1938 a long-range program for the replacement of over-age cargo and passenger-cargo vessels with new and speedier ships at the rate of 50 ships a year for a ten-year period. After the outbreak of war in Europe in 1939, this program was accelerated and expanded. In 1942 more than 8000 deadweight tons of shipping were produced by American shipyards, and by mid-year of 1943 production had attained an annual rate of 1800 to 2000 ships, having a combined capacity of more than 19 million deadweight tons. By the end of the war, the United States owned an ocean-going merchant fleet of approximately 60 million deadweight tons, composed of some 5000 sea-going merchant vessels of 2000 gross tons or over—around 60 per cent of the world's total tonnage of merchant ships. This represented an investment of more than 16 billion dollars.<sup>26</sup> In 1939 about 12 million deadweight tons—15 per cent of total world tonnage—was under our flag.

### CONCLUSION

Will our attempt to assure the maintenance of a modern and adequate foreign trade fleet after this war prove any more successful than our policy after World War I? Prior to 1939 all attempts to maintain a profitable merchant marine had failed. A study of the income statements of American shipping companies reveals that American ships can maintain themselves in an international competitive market only with the help of substantial government sub-

<sup>26</sup> To assure the most effective utilization of this shipping, a War Shipping Administration was established in 1942, to which were assigned the Maritime Commission's powers relating to the operation, purchase, insurance, repair, maintenance, and requisition of vessels. The WSA secured either title to, or the use of, practically all privately owned sea-going vessels of 1000 tons capacity or over, as well as those ships produced in the construction program of the Maritime Commission, and those requisitioned and purchased by the Commission prior to Pearl Harbor. The Administration conducted and supervised ocean merchant shipping through agents, most of whom were long-established steamship operating companies.

sidies, except in times of great prosperity, when shipping is scarce and freight rates are high. If the government is willing to dispose of its ships to private industry for a nominal charge and charge off the costs of construction as a war expense, it may be possible for American ships to operate at a profit.

For the immediate future, the American merchant marine promises to be superior in quality to other merchant fleets so that the operation of American vessels may be lucrative even if subsidies are curtailed. But, as rival nations replace their ships lost during the war, and insurance funds are available to finance replacement, this American superiority will gradually disappear, and, without an adequate replacement program of our own, may become an inferiority. The convincing experience of the nineteen-twenties may then repeat itself. American shipping companies will be unable to accumulate sufficient funds for replacement, and after a decade or two the volume of American tonnage may have shrunk to a small fraction of its initial size. Without substantial and continual subsidies, there appears little likelihood that this country can maintain shipping and shipbuilding industries of a size commensurate to the popular estimate of the country's commercial and defense needs.

How large a foreign trade fleet should the United States support after the war? The Chairman of the Maritime Commission has pleaded that a merchant fleet of from 15 to 20 million deadweight tons will be necessary for our national defense and to carry 50 per cent of our export trade, which he deems desirable. After the bitter experiences of the war, it may not be difficult to convince the American people of the necessity for such a vast ocean-going fleet. But the maintenance of a huge merchant marine by a nation which labors under a comparative disadvantage in shipping and shipbuilding raises other problems. The first is the cost. Under the modest original program of the Maritime Commission, construction and operating subsidies amounted to 125 million dollars for the first four years (to June, 1941). One writer has estimated that subsidy payments of 400 to 500 million dollars a year would be necessary to maintain a foreign-trade fleet of 20 million deadweight tons.<sup>27</sup>

More important than cost, however, is the effect which the opera-

<sup>27</sup> J. Hans Adler, "British and American Shipping Policies: A Problem and a Proposal," *Political Science Quarterly*, Vol. LIX (June, 1944), p. 214.

## 608 International Trade and Commercial Policy

tion of an American foreign trade fleet several times its prewar size would have upon the economies of other nations. For some foreign maritime nations, shipping is an important source of foreign exchange. This is true of Norway. Shipping is her largest single source of foreign exchange, and in normal prewar years paid for approximately one-third of the country's imports. The comparable figures for Great Britain and the Netherlands are about 10 and 8 per cent, respectively. If a larger share of international commerce is to be carried by the American merchant marine, less must remain for foreign merchant marines—with a consequent diminution in the amount of foreign exchange available to them. This can only reduce the markets for American products abroad and weaken the prospects for a reasonably speedy reconstruction of foreign economies. An attempt to make up the loss of traffic to allied countries by prohibiting international shipping to the defeated Axis nations would merely shift the burden of adjustment, without eliminating it. The postwar shipping problem is therefore more than a purely domestic matter; it is a segment of the far broader problem of the health of the international organism.

Uncertainty concerning our possible involvement in war within the next few decades requires that we maintain a national merchant marine sufficient to safeguard our national existence. An active tonnage of 12 million deadweight tons consisting of new, fast ships, kept in condition for continuous operation, might represent a reasonable minimum provision for national security. This active fleet could be supplemented by a laid-up fleet of another 10 million tons, rigidly restricted to wartime use only, but capable of being put into service quickly; the experience of the recent war has demonstrated that ships laid up as long as twenty years can be reconditioned for practical service as carriers of merchandise. To ensure against a sudden, critical shortage of merchant ships that might threaten our national security, it will also be necessary to maintain a certain minimum of domestic shipbuilding facilities. To the extent that international cooperation in the future may succeed in reducing the possibilities of war, the need for maintaining a national merchant fleet will become less pressing, and we can give greater weight to economic considerations in obtaining our shipping services. After providing for this minimum active and laid-up fleet, the remainder of

our existing tonnage of serviceable and efficient ships might be sold to countries among the United Nations that have suffered heavy losses of tonnage during the war. Such transfers would contribute in an important way to restoring the economies of these countries, and the world economy, to health, and would make it unnecessary for the United States to pay huge subsidies in order to keep in operation, or in reserve, an unnecessarily large number of ships.<sup>28</sup>

#### INTERNATIONAL AIR TRANSPORT

No discussion of international transportation policies would be complete without at least brief mention of the newest entrant into the field—air transport. The invention of the airplane has initiated a new manufacturing industry and a new transportation industry which has opened new areas to world commerce. It has also made both the individual and the state less secure under conditions of international anarchy. How air transportation will affect land and sea transportation, commerce, travel, and cultural interchange, it is still difficult to say; but it seems likely to create more frequent contacts of widely separated peoples and economies, more social, economic, and political interdependence, and a rapidly shrinking world. Whether such consequences will work for the improvement of living standards depends in no small degree upon the organization of commercial air lines, the facilitation of technical advance in air navigation, and the way in which security and commercial considerations affect one another. It must be kept in mind that the airplane was first put to large-scale use not in peace, but in war. Considerations of national interest—military, political, and economic—have been, and in the present status of world affairs are likely to remain, the predominant factors in the development of this new means of communication and transportation.

*Public Control.* Because of the military and political importance of air transport, the industry has been subjected to government controls which are probably more extensive than those applied to any other means of transportation or communication. Governments in general exercise control over foreign flag air carriers within their own territorial jurisdictions, and over carriers of their own nation-

<sup>28</sup> See Calvin B. Hoover, *International Trade and Domestic Employment*, Ch. VII.

## 610 International Trade and Commercial Policy

ality irrespective of the place of operations. There are two distinct ways in which governments exercise control over air transport: (1) through regulation, and (2) through participation in the ownership or management of air transport enterprises.

The safety of air transport operations has been made the special concern of governments. Governments have almost universally provided for the inspection and licensing of the equipment and personnel of air transport enterprises and for the promulgation and enforcement of air traffic rules. Governments have also shown deep concern with the regulation of such matters as the nationality of owners of air transport enterprises, competition between air carriers, the establishment and abandonment of air lines, labor standards in the industry, and rates.

Since the great powers regard air transport primarily as an instrument of national policy, there has been a growing tendency for governments to exercise a more intimate control over air transportation by participating directly in the ownership and management of such enterprises. Government participation has generally assumed one of the following forms: (1) government appointment of one or more directors or officers in otherwise privately controlled enterprises; (2) government ownership of capital stock in air transport corporations—such ownership may embrace a minority, a majority, or all the stock of a corporation; (3) the formation of a public corporation with government-appointed directors; (4) the operation of air transport services directly by a government department. The United States is today the only important air power in the world whose government has no direct share in the ownership or management of any commercial air transport enterprise.

*Public Aid.* Air transport in practically all parts of the world has been unable to exist without public aid in direct and indirect forms, and intercontinental air transport has been further removed from self-support than air transport within a single continent. The greater financial dependence of intercontinental air transport is to be found in the relatively greater importance of political and military factors in shaping the development of international air services than in shaping that of domestic services, the higher costs of operation of intercontinental routes, and the necessity for transport companies to maintain their own airways and airports abroad. Direct public aid

to air transport tends to assume the form of subsidies and mail payments, while indirect public aid has assumed the form of the provision of ground facilities by the state or local government at little or no cost to the carriers. The government may also aid air transport companies by subscribing to their capital, guaranteeing their security issues, exempting them from fiscal obligations, and in a variety of other ways. The amount of public aid is usually calculated to cover at least the operating deficits of the carriers, in order to assure their continued existence. In return for public aid, carriers ordinarily assume certain obligations toward their governments, such as the reduction of fares for government officials, the operation of services that are not commercially profitable, and the use of home-produced equipment which may not be the best or the least expensive on the market.<sup>29</sup>

*Costs and the Scale of Production.* If civil aviation is to serve human needs, it is imperative that costs of transport be brought down to the lowest possible levels. Economical operation and continuous advance depends upon providing every incentive and opportunity for improvement, lower costs, and lower prices. Separate incentives and opportunities will be more numerous the greater the number of independent organizations. What one administration may reject may be accepted and rewarded by another. The larger the number of firms, furthermore, the greater are the chances for promotion to top jobs in the industry, and the stronger the incentive provided by prospects of personal promotion. To insure these advantages of numbers, there should be protection against restrictions by industry and trade associations, rate associations or conferences on the freedom of competitive action.<sup>30</sup>

It is frequently argued that air transport is an industry in which small-scale firms and low-output operations are not the most efficient, that the industry is by nature monopolistic. Students of transportation are today, however, coming to suspect that the importance of increased scale and high levels of output to lowered costs has been overdrawn. Dr. John B. Crane found that air carriers of me-

<sup>29</sup> See Oliver James Lissitzyn, *International Air Transport and National Policy*, New York, 1942, Ch. IX. This work contains an able and comprehensive discussion of international air transport.

<sup>30</sup> See Kent T. Healy, "Workable Competition in Air Transportation," *American Economic Review*, Vol. XXXV (1945), no. 2, pp. 229-242.

## 612 International Trade and Commercial Policy

dium size in the United States in 1940 and 1941 had as low, or lower, average unit costs as carriers of much larger size.<sup>81</sup> A condition of constant costs appears to be characteristic of the industry after a certain scale of operations, often not very large, has been achieved. Crane concludes that air transportation is essentially competitive in character—air competition tends to be imperfect rather than pure, however—and that, with the anticipated rapid increase in the volume of air traffic, a larger number of air carriers than now certified by the government would be economically justified.

*The Diplomacy of International Air Transport.* The development of international air transport has been restricted by the legal and diplomatic framework within which it has had to develop. This framework is based upon three simple, yet fundamental, principles: (1) each state has complete and exclusive sovereignty over its territory, including that of its colonies, and over the territorial waters adjacent to the country and its colonies; (2) each state has complete discretion as to the admission or non-admission of any aircraft to the air space under its sovereignty; and (3) the air space over the high seas and other parts of the earth's surface not subject to any state's jurisdiction is free to the aircraft of all states. The International Convention for Air Navigation adopted by a large number of states at Paris in 1919 gives to the aircraft of each signatory state the right to cross the air space of another state without landing, provided it follows the route fixed by the state over which the flight takes place. At the same time, it makes the establishment of international airways subject to the consent of the states flown over.

The necessity of bargaining for landing rights has exercised a retarding effect on the development of world air commerce. The power to withhold from foreign aircraft the right to cross, or to land on, their territory is used by most national states as a bargaining weapon to their own advantage. Many routes that are technically feasible and commercially promising have remained unopened. Small, but favorably situated, countries have at times exacted in return for the grant of landing rights conditions that have become financially burdensome to the foreign carriers involved. The free development of international air commerce may also be threatened

<sup>81</sup> "The Economics of Air Transportation," *Harvard Business Review*, Vol. XXII (1944-1945), pp. 495-508.

by the securing of a monopoly of landing rights at important points by a single company. Air transport relations between nations frequently follow the trend of their general political relations. The admission of foreign aircraft to one's own soil is proof of confidence and friendship that has great political significance. States are afraid that their potential enemies will observe their bases, fortifications, and other preparations for war, or will make surreptitious aerial surveys of their country. They also fear that foreign pilots flying the route will become so familiar with local weather conditions, terrain, and ground facilities that a future aerial invasion of the country will be greatly facilitated.

The United States Air Commerce Act of 1926 lays down in general terms the principle of reciprocity for the granting of air navigation privileges. Nevertheless, in granting landing rights to foreign carriers, careful consideration is given to national interests. The Secretary of Commerce in 1937 refused the application of the Dutch Royal Air Transport Company for landing privileges at Miami, and in 1938 British and Dutch companies were denied landing privileges in Hawaii—for military reasons.

*The International Conference on Civil Aviation (1944)*. At the International Conference on Civil Aviation held at Chicago in 1944, there was a strong movement to secure the acceptance by all the participants of the five freedoms of the air: (1) freedom of transit through foreign air space, (2) freedom to land on foreign territory for refueling, (3) freedom to put off on foreign territory goods and persons originating in home territory, (4) freedom to take on goods and passengers destined for home territories, and (5) freedom to take on or put off goods and passengers at intermediate points on routes beginning or ending in home territories. It was believed that these five freedoms would permit competition to preserve the efficient and bankrupt the inefficient carriers, and thus assure good service at reasonable rates to all users of commercial air lines. The negotiations only produced a compromise, however, whereby an International Civil Aviation Organization is to have extensive powers of recommendation on technical matters, but only limited powers on commercial matters. The freedoms of transit and technical stop (numbers 1 and 2) were accepted by a large number of the delegations, but the commercial freedoms (numbers 3, 4, and



## 614 International Trade and Commercial Policy

5), while incorporated in an agreement opened for signature, were accepted by a much smaller number. The unwillingness to create a free competitive situation was provoked by the actual economic situation existing at the time of the conference. Some states were producing more aircraft than others; some were operating more airlines than others; one state was manufacturing most of the transport planes and operating most of the international air transport lines, while others were producing combat planes and engaging in little air transport. The ideological differences between the advocates of free-enterprise economies and controlled economies, between nationalists and internationalists, and the governmentalization of the airlines of some nations while those of others were operated by private enterprise added to the difficulties of reaching agreement.<sup>32</sup>

The economic development of international air transport has been, and in the absence of an effective system of collective security will continue to be, conditioned by the fact that air transport is regarded and used as an instrument for the promotion of the national interests of sovereign states. The ratification of the Chicago conventions by a large number of nations and the future evolution of international commercial aviation toward improved services, lower costs, and lower rates depend in no small measure upon the degree of confidence in the attainment of collective security in the postwar era. If confidence in the ability of the United Nations to guarantee national security should be destroyed, national states would probably consider aviation, both civil and military, primarily from the standpoint of defense, and the realization of the objectives of the Chicago conference would be jeopardized.

. . . small states incapable of manufacturing or operating enough planes to defend themselves would feel obliged to put themselves under the explicit or implicit protection of a great neighbor. The great states themselves would probably attempt to prevent foreign made airplanes and foreign operated commercial air lines from entering their territories and 'spheres of influence' in order to be sure of the bases, the manufacturing plant, the air men and the know-how from which might be developed a vast military air force in case of attack. Each great state might,

<sup>32</sup> See Quincy Wright, "The International Regulation of the Air," *American Economic Review*, Vol. XXXV (1945), no. 2, pp. 243-248.

however, attempt to go further and to develop its air lines throughout the world in order to acquaint itself with distant bases and flying conditions, and to hamper the development of rival aviation systems. We may be sure that such attempts to penetrate the spheres of other great powers would be resented. Each would try to monopolize its sphere. In this situation, where the security of each would rest on its relative power, the three or four great powers would regulate commercial aviation primarily in the interest of national and imperial power. The convenience and needs of the traveling and shipping public would be given only secondary consideration. National aviation rivalries in both the military and commercial sphere would provide an index of national power rivalries and a prelude to new world wars.<sup>33</sup>

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<sup>33</sup> *Ibid.*, p. 247.

## *Colonies*

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Not all world trade originates in countries which are politically independent. Approximately 30 per cent of the land area of the globe consists of territories which are owned or controlled by a limited number of world powers, most of whose metropolitan areas are comparatively small; in these colonial territories reside nearly one-third of the world's inhabitants. The external trade of these dependent territories constitutes somewhat more than one-fifth of total world trade.<sup>1</sup> The controlled territories, with few exceptions, have economies almost totally different from those of the home areas of the colonial powers. Trade with colonies thus becomes important by virtue not only of its proportion to total world trade, but also, because of its essential nature, as a necessary complement to the economies of the industrially advanced nations. The policies which govern the economic development of these colonies and their relationship to the mother country and other states assume, therefore, great significance in the modern world economic order.

The colonial problem was brought into sharp focus in the two decades between the signing of the Treaty of Versailles and Hitler's invasion of Poland by the grumblings, demands, and threats of the Germans, Italians, and Japanese. In the peace settlement of 1919, defeated Germany was stripped of her entire colonial holdings, while Italy and Japan did not receive as great a share of the spoils of war as they believed themselves entitled to, in view of their contributions to victory. Most of the German colonies and parts of the old Turkish Empire were taken over by Great Britain and France.

<sup>1</sup> Colonial trade averaged 21.5 per cent of world trade in the five-year period 1929-1933.

The "have-not" powers—Germany, Italy, and Japan—protested loudly and vehemently that their lack of adequate colonies restricted their economic development; that their populations were condemned to standards of living inferior to those enjoyed by the peoples of the powers more abundantly endowed with colonial possessions—the "haves"; that only the acquisition of extensive and rich colonial territories could relieve their population pressure, provide adequate markets for their products, and assure to them sufficient supplies of raw materials. It was by such arguments that Italy sought to justify in the eyes of the world her campaign for a vast African empire, Germany her war for *lebensraum*, and Japan her crusade for a "Greater East Asia Co-Prosperity Sphere."

It is the purpose of the present chapter to outline modern colonial development, to examine the motives which have impelled nations to acquire colonies, to analyze colonial economic policies, and to appraise the economic advantages of possessing colonial territories.

#### WHAT ARE COLONIES?

The word "colony" is frequently used, in the broad sense, to refer to a territory which acknowledges the sovereignty of some outside state over it. The subtle and constantly changing political relations of the world's territorial divisions defy, however, simple or hard and fast definition and classification. Degrees of political dependence vary widely, and include such relationships as are represented by the British self-governing dominions,<sup>2</sup> protectorates, spheres of influence, mandated territories, and assimilated territories, as well as colonies in the strict sense.<sup>3</sup> For the purpose of economic interpretation, a satisfactory definition has been offered by Professor Dietrich;<sup>4</sup> this describes a colony as "a territory outside the boundaries of the mother country over which the latter has the right to make ultimate decisions on commercial policy." The distinguishing features of a colony are, in other words, that the control of its legislation regulating imports and exports and the sole power to make its commercial treaties reside in a foreign sovereign state.

<sup>2</sup> Not classified as colonies.

<sup>3</sup> United States Tariff Commission, *Colonial Tariff Policies*, pp. 5-12.

<sup>4</sup> Ethel B. Dietrich, *World Trade*, Henry Holt and Company, p. 307.

## 618 International Trade and Commercial Policy

### LOCATION AND PRODUCTS OF COLONIES

Although colonial territories in the present day are widely scattered among several continents, they are practically all situated in tropical or subtropical regions, that is, most of them lie within 20° of the equator. Their climatic conditions are therefore unsuitable for outdoor labor by people of European stock. Most colonies, furthermore, are already fairly densely populated, relative to their natural resources and economic opportunities, and for this reason do not offer possible outlets for large-scale immigration from more economically advanced countries. In other words, they are of little use for relieving any pressure of population in the metropolitan countries.

The inhabitants of colonial areas are engaged almost entirely in the production of primary products—chiefly agricultural commodities, but partly minerals. Their chief mineral products are tin, copper, gold, petroleum, and phosphates. From colonial territories comes over one-half the world's tin and about one-quarter of the world's copper. Colonies account, however, for only a small proportion of the world's output of petroleum and gold. Of agricultural products, the colonial production of one, natural rubber, in 1939 accounted for practically the whole of the world supply; this came largely from the British and Dutch colonies in Asia. Colonial territories are also responsible for most of the world's production of palm-oil and palm-kernels, although these are only one of many competing sources of vegetable oils. Other important agricultural commodities that are largely produced in colonies are tea, sugar, cocoa, coffee, bananas, oranges, grapefruit, and cotton. The total production of all colonies accounts, however, for only about three per cent of the total world output of all commercially important raw materials. This low percentage reflects the negligible, or small, contribution of colonies to the production of the principal raw materials: wheat, meat, and wool among agricultural products, and coal and iron ore among non-agricultural products.

### PERIODS OF MODERN COLONIAL DEVELOPMENT

The Phoenicians and Greeks in ancient times founded important colonies along the shores of the Mediterranean, and utilized them

chiefly as trading centers for their merchants. In the main, no special interest was accorded these colonies, although colonial trade was upon occasion the subject of legislation by the home state. Rome placed less stress on commerce than did the Phoenicians and Greeks, but the extensive Roman colonies were forced to pay tribute in the form of shipments of grain to feed the Roman population. The era of modern colonization began with the commercial and industrial revolutions, both of which brought a greater territorial division of labor and a concentration of manufacturing in England and western Europe, with a corresponding dependence upon non-European areas as sources of raw materials and markets for finished products. The systems of colonial control that were set up were directed primarily, though not exclusively, by economic considerations.

Modern colonial development has passed through three main phases. From the latter half of the fifteenth century to the Napoleonic wars, the Portuguese, the Spanish, the Dutch, the French, and finally the English were successively paramount in exploration, discovery, and colonization. The period is characterized by the exploitation of the colonies for the profit and aggrandizement of the mother country. This process of exploitation, known as the colonial system, formed a part of the mercantilist system of legislation, which has been more fully treated in Chapter II. The colonial powers set out, at first, to wrest from the colonies their reputedly fabulous stores of precious metals. The general disappointment caused by their failure to find any precious metals, except in the Spanish colonies, brought a shift in policy to one which undertook to establish colonies as sources of raw materials and as markets for the finished products of the metropolitan country. To these ends, the development of manufacturing industries in the colonies was discouraged; certain types of extractive industries were encouraged, even to the point of subsidization; the trade of the colonies was monopolized by the government, a chartered company, or nationals of either the mother country or the colonies; the use of ships owned by nationals of other countries in the colonial trade was discouraged or even forbidden by law. The colonists became dissatisfied with this system, and their discontent led to the eventual breaking away of important colonies. The revolt of the British colonies in North America in the late eighteenth century and of the Spanish and

## 620 International Trade and Commercial Policy

Portuguese colonies in Latin America in the early nineteenth century created misgivings concerning the soundness of the colonial system and led to its gradual relaxation.

During the second phase, which covers the first three-quarters of the nineteenth century, interest in colonies waned, except in the case of the French who had lost virtually their entire vast colonial empire. The absolutist policy toward colonies gave way to one of moderation. The basic reason for this change was a realization that a system of exploitation did not pay, but the new liberal attitude was also supported by an anti-absolutist movement in western thought which affected politics, religion, and literature as well as economic policy. The new spirit of individualism found expression in the American and French Revolutions and in the capitulation of mercantilist doctrine to the economic philosophy of *laissez-faire*. Relaxation or abandonment of trade barriers and colonial preferences was accomplished through a system of commercial treaties which in England brought virtual free trade by 1860 and in France the abandonment of colonial preferences by 1861. Industrialization absorbed both the capital and the energy of western powers during these decades and left little of either for the waging of costly imperialistic wars. Business and political leaders were beginning to realize, also, that their European neighbors could be just as valuable customers as their colonies.

After the Franco-Prussian War, a remarkable revival of colonial expansion occurred. The rise of a vigorous new nationalism, particularly in Germany and Italy, emphasized the importance of colonial possessions to any nation which aspired to a seat among the great. The further growth of industrialism, the consequently keener competition for markets, and the strengthening of the protectionist movement in western countries accentuated the need for markets to absorb the surpluses of the machine technique. Colonies seemed to offer the desired outlets. After the Berlin Conference on the Congo (1884-1885), there was a general stampede to stake out holdings in Africa, and new explorations led to the creation of colonies and spheres of influence there. British holdings in Africa, Asia, and Oceania grew to four times their former size, French holdings to sixteen times their former extent. Germany, Belgium, Italy, Japan, and the United States gained places in the charmed circle of colonial

powers. Colonies were acquired by conquest, by purchase, by economic penetration, and by amicable agreement. Trade with colonies became increasingly important. On the eve of World War I, the total trade of colonial empires was over three-fourths of total world trade, although the trade of colonies alone amounted to scarcely one-fifth of the world total. The importance of colonial trade for the mother country varied considerably, however, ranging from an estimated 35 per cent of the total external trade of Great Britain to less than one per cent of that of Germany and Italy.

By the peace settlement of 1919, Germany was divested of her entire colonial empire and Turkey of her Asiatic possessions. These territories were reallocated among the victorious powers under the administration of the League of Nations, and were called "mandates." The mandatory powers did not theoretically have sovereignty over these mandates, but rather held them in trusteeship for the League of Nations. The chief beneficiaries of the redistribution of former German and Turkish possessions were Great Britain and France; Belgium and the Union of South Africa received certain African territories, while Japan, Australia, and New Zealand were awarded Germany's Pacific islands.

#### WHY COLONIES HAVE BEEN SOUGHT

The explanations of this scramble for colonies that have won the most widespread support are based upon economic considerations. Some hold that imperialism (the political domination of foreign peoples) is the inevitable product of the capitalistic form of production and exchange and can only disappear with the advent of universal socialism. Others maintain that it is traceable to the maladjustments of capitalism. Both views rest upon similar arguments. It is argued, first, that the high productivity of modern machine technique, coupled with an inequitable distribution of the product and the erection of trade barriers by industrial nations, has made it difficult to dispose of manufactured goods, and has consequently forced manufacturers to seek entirely new outlets where there are no tariffs and where goods may freely be sent—in other words, colonial markets. Second, as the number and size of factories increased and the technique of production improved, industrialists were able to accumulate ever larger profits. Although these profits



## 622 International Trade and Commercial Policy

could at first be advantageously reinvested at home or in other industrialized states, eventually these investments yielded such an accumulation of capital that a surplus of capital accrued which sought more profitable outlets than were available in the highly industrialized areas. Because money invested in the more backward regions would bring higher returns than money invested at home, bankers and financiers in most of the industrial states gradually came to view the acquisition of colonies as an excellent means of gaining additional outlets for the investment of their surplus funds.

It is further argued that the phenomenal increase of population in the nations of western Europe during the eighteenth and nineteenth centuries—the accompaniment of industrialization, the expansion of markets, and the development of the new world—raised fears of over-population, with its low living standards and growing number of people dependent on charity. Emigration offered a solution to over-population. But the advocates of emigration did not like to see their fellow citizens going to foreign countries to add to the manpower and manual and technical skills of immediate and potential rivals, so they reasoned that political control over these areas of destination must be secured by the mother country. Finally, greedy factories and hungry factory towns called out for raw materials and foodstuffs. Since much of these had to be imported anyway, how much more desirable it would be if the lands from which they came were under the political control of the mother country so that, come what might, one would not be dependent upon foreign favors for these vital supplies.

Although economic factors have been the main basis for the reasons presented in support of colonies, they have by no means been the only basis. It is doubtful whether, in many instances, economic factors have, after all, played the principal role. Many strategically located islands have been seized for naval bases and as vantage points from which to refuel ships and keep a watchful eye on national merchant fleets. In every country, too, there have been persons who wanted to help the benighted natives of the world's "backward" areas to see the light, both spiritually and materially; who wanted to save the souls and clothe the bodies of these natives according to their own special type of Christian civilization.

Such Christianizing pursuits could be carried on to much better advantage if the altruists' own country actually controlled the natives. Last, but certainly not least, among the causes of modern colonial expansion have been national pride and prestige. This is what the German Chancellor Bülow meant in 1897 when he said, "We do not want to put anyone in the shade, but we demand for ourselves a place in the sun." Benito Mussolini gave expression to the same sentiment 30 years later when he admonished the Italian people: "In order to be of importance in the world, Italy must begin the second half of the century with at least sixty million inhabitants. . . . If our numbers decline, gentlemen, we shall not found an empire, we shall be degraded to a colony." Solicitude for national prestige is responsible for the belief that a nation, if she is to be great, must punish atrocities to her people or insults to her flag, and protect her citizens and their property in other countries. National honor is at stake also when two nations contend for the dubious privilege of conquering a backward nation.

Not every citizen of the colonial powers was interested in these arguments for colonial expansion. The appeal was rather to certain groups which, though frequently numerically small, were powerful, well organized, and active. These "apostles of expansionism" included many business groups: exporters, importers, manufacturers of goods used in backward territories (textiles, medicine, machinery, armaments, uniforms, and telegraph and railway materials), shipping magnates, and bankers. These business interests found ardent allies among military and naval officers, diplomats, colonial officials and their families, missionaries, explorers, adventurers, and politicians. Politicians and statesmen became expansionists from patriotic reasons, in response to public clamor, to take the minds of the people off unfavorable domestic conditions, or to enhance their personal glory and make a place in history for themselves as empire builders.

Colonies may seem to be of little benefit to the masses of the people in the metropolitan country, who have no colonial investments, and to many, perhaps most, business men. They may, in fact, be directly contrary to the economic interests of certain business groups, e.g., American sugar producers who are forced to compete in the domestic market with duty-free imports of Hawaiian and

## 624 International Trade and Commercial Policy

Philippine sugar;<sup>5</sup> or French wine producers who must compete in the French market with duty-free Algerian wines. The costs of the conquest, protection, and administration of colonies, furthermore, add to the tax burden of the entire citizenry. The minority groups usually succeed, nevertheless, in convincing the majority that colonial expansion is in the interests of everybody. Appeal to the principles and ideas of altruism, national honor, surplus population, self-protection, national wealth, and economic nationalism rallies the public to valiant feats of empire building. The initiative is taken by the interests; the support is given by ideas, and by the people.

### COLONIAL ECONOMIC POLICIES

#### (1) TARIFFS

Colonial economic policy since 1875 has been characterized by a system of neo-mercantilism, a system more refined and indirect than the old colonial system, which revolves principally about discriminatory differentials in tariffs and shipping.

Colonial import tariff systems are of three general types: assimilation, preference, and the open door.

*Assimilation.* Tariff policy is termed "assimilation" when the rates of duty on imports into the mother country are also enforced in the colony, the trade between the two units being free. France in 1892 adopted assimilation as its general policy, although it still has preferential and open-door areas. Japan adopted assimilation in 1909 for Formosa and Karafuto, and in 1920 for Korea. The United States employs assimilation in Puerto Rico.<sup>6</sup> Since schedules of duties are framed primarily for the protection of domestic manufacturers, the policy of assimilation reserves for producers of the mother country the colonial as well as the home market. The products of the colonies, however, which usually differ from those of the metro-

<sup>5</sup> Under the Philippines Trade Act of 1946, Philippine exports to the United States are to be duty-free, to the extent that they were before the Philippines attained independence, until 1954. For twenty years thereafter (until 1974) Philippine exports to the United States are to be subject to a progressively increasing tariff, until by 1974 United States trade with the Philippines is to be on the same basis as trade between the United States and other independent nations. In addition, Philippine exports of certain items are to stay within the volume of quotas during this period.

<sup>6</sup> Alaska and Hawaii have a "territorial" status and are not regarded in the United States as "colonies."

politan country, gain practically nothing from assimilation because colonial interests have little or no direct representation in the national legislature, and the blanket of protection is not apt to be extended to them. Infrequently, the national legislature has voted duties for the special benefit of colonies, as, for example, the French duty on rice.

Free entry of colonial products into the mother country is not as valuable to the colonial products as is free entry to the protected markets of the colonies to the industrial products of the mother country. For colonial products are chiefly raw materials, which usually enter importing countries duty-free or at low rates of duty, whereas many industrial products are widely subjected to import duties, frequently highly protective duties. The free admission into the mother country of certain important commodities which are usually taxed by the mother country for revenue purposes—sugar, tobacco, coffee, and cocoa—may, however, give such colonial products a decided advantage. But the advantage to colonial producers will amount to little more than the assurance of favorable treatment in a known market unless the mother country can absorb more than the entire colonial production. If consumption in the metropolitan market exceeds the colonial output, so that part of the supply has to be imported from foreign countries, the price prevailing in the metropolitan market will be the world price plus the duty, and this is the price which colonial producers will receive. If, on the other hand, less than the whole colonial output can be disposed of in the metropolitan market, the rest must be sold in foreign markets at the world price; the ruling price for it all will then be the world price, less the transport costs to the dominant market. In this case, the colonies will derive no price benefit from the metropolitan tariff.

*Preferential Tariff Policy.* Assimilation is the most extreme preferential policy. The term "preferential tariff policy" ordinarily refers, however, to a system in which the mother country and the colony have different tariffs, but in which each reserves for the other certain privileges—in the form of partial or complete exemption from import duties, export duties, or quotas—not granted to foreign nations. Although colonial tariff rates are occasionally higher than those of the mother country, normally they are lower. General

## 626 International Trade and Commercial Policy

commercial treaties, which before World War I usually contained the most-favored-nation clause, have in some cases given preference to colonies; in others, they have provided opportunities for further preference by excepting the colonies. Italy used the preferential system to a large extent when she held colonies; and Spain and Portugal have, in the main, continued their preferential systems. The United States employs preference in the Philippines, the Virgin Islands, and Guam. Within the British Empire, empire preference has increased since 1919. Reference has already been made<sup>7</sup> to the three-level tariff schedules of Canada and Australia whereby products of the mother country enter at the lowest rates, those from most-favored-nation countries at the intermediate level, and all others at the highest rates. Upon a comparatively small number of items dutiable at relatively low rates, the preferential reduction takes the form of free admission.

The extent of the preference granted by the several tariff policies varies widely. In the case of low colonial tariffs for revenue, the preference granted the mother country is frequently the major proportion, or the full amount, of the duty. When tariffs are for the purpose of protecting young industries, the preference is not so generous. Often the reduction is two-fifths, or less, of the regular rate. Preferences in the colonial market are usually accompanied by preferences to colonial products in the home market, but the extent of the two is by no means always comparable. The United States grants free entry to the products of the Philippines (until 1954). Portugal, however, gives Angola only a 50 per cent reduction, compared with a reduction of 90 per cent in the latter. On the basis of the percentage of reduction granted, the United States and Japan rank first, followed by Portugal, France, Italy, Spain, the British Dominions, and the British Crown Colonies.

Preferences have also been given in respect to import quotas. The adoption of an import-quota system by the mother country has commonly been followed by the establishment of a colonial import-quota system. Prior to 1939, imports into the British colonies from the mother country were exempt from colonial quotas. French exports to the colonies were either exempted or given favorable quota allocations, while colonial imports into France were entirely ex-

<sup>7</sup> Ch. XI.

empted from the quotas of the mother country. Various minor and indirect types of preference may be used. These include open discrimination in minor duties and fees, discriminatory classifications, concealed discriminations through discretion in valuation, enforcement of merchandise-marks acts, and similar devices.

Preference, like assimilation, usually bestows far greater benefits upon producers in the mother country than upon those in the colonies, and for identical reasons. Where a large percentage of colonial trade is with the mother country, a policy of assimilation or preference may, furthermore, reduce colonial revenues below needs, or prevent the development of certain industries in the colonies.

*The Open Door.* The policy of the "open-door" involves economic, commercial, and industrial equality within the colony for all nations; there is no discrimination in favor of the mother country. The principle of the open-door is not to be confused with free trade; it implies simply equality of treatment for all. In an open-door regime, a tariff may be devised either to protect local industry or for revenue only. The rates in open-door tariffs are, however, usually lower than those in either the assimilated or the preferential systems. The Netherlands, Belgium, and Germany before 1919 followed in general the open-door policy, with moderate tariffs, and the United States employed this system in Samoa and the Canal Zone. From 1860 to 1919 Great Britain maintained the open-door in India and most of the crown colonies, with either free trade or low revenue tariffs, but, as a reaction to postwar economic nationalism, empire preference gradually supplanted it. Where the open-door with moderate duties has been found in certain of the colonies of countries whose prevailing policy has been assimilation or preference, e.g., France, Portugal, Spain, and the United States, the exceptions have usually been made because of treaty or similar obligations. The post-1920 development of protectionism, and the intensification of Japanese competition caused the gradual abandonment of the open-door, so that the only territories in which the policy has survived are the mandates and those areas still governed by international agreement—Morocco, the Congo Basin, and British West Africa.

*Export Duties.* Although export duties had nearly disappeared from the European tariff structure by 1913, they continued to be of

## 628 International Trade and Commercial Policy

importance in colonial policy. Export duties are ordinarily levied at lower rates than import duties because their purpose is primarily fiscal. Colonial export duties on raw materials have a protective effect upon the industries using those materials. In few instances, however, has protection for local industry been the object of imposing export duties in colonies. The protection has been sought rather for industries in the mother country, and this has been attained by granting preferential reductions on exports destined for the mother country. Conservation is sometimes an object of an export duty, though this end is more frequently sought by prohibition. Export duties are also levied in connection with the grading and inspection which are done to raise the average quality and better the reputation of the article exported.

Preferential features do not appear so frequently in export duties as in import duties. In the Portuguese colonies alone might they be said to have constituted a national policy. Some use of preferential export duties has been found, however, in certain individual colonies of other powers, e.g., in French Indo-China, Spanish Fernando Po, and Italian Somalia.<sup>8</sup> Great Britain has at times employed preferential colonial export duties to foster a monopolistic use of three raw materials: tin ore, palm kernels, and hides and skins. These cases and the entire subject of export duties are treated more completely in Chapter X.<sup>9</sup> Export duties have not, on the whole, been widely used in colonial tariffs.

### (2) SHIPPING POLICY

Economic interests in the mother country may be nurtured not only by discriminatory colonial tariff systems, but by discriminatory shipping policies as well. The interests benefited in the two instances, however, differ. Preferential tariffs favor primarily domestic merchants and manufacturers; preferential shipping regulations favor domestic shipping interests.

Colonial shipping policies are of four main types. First, metropolitan-colonial and intercolonial trade may be open to the vessels of all nations without discrimination, as in some of the British,

<sup>8</sup> *Colonial Tariff Policies*, pp. 51-52.

<sup>9</sup> See pages 232-240.

Dutch, Belgian, and the former German colonies. The Netherlands have allowed the vessels of "reciprocating countries" to engage in the trade between the home country and the colonies. Second, this trade may be open to the vessels of all nations, but preferential tariff rates given on dutiable commodities may be granted only when commodities are transported directly from the country of origin; this is true of some of the British dominions and British and French colonies. Third, preferential tariff rates or additional preferences may apply only if goods are carried in vessels of national registry, as in the case of Portugal. Fourth, the trade between the mother country and the colonies, and the intercolonial tradé, may be closed to all ships except those under the national flag. Spain, Portugal, Japan, and the United States have at various times employed such a policy. This trade may also be regulated by agreement. Under an agreement of 1936, for example, the Netherlands agreed to permit 64½ per cent of Japanese exports to the Netherlands Indies, and 60 per cent of the exports of the Indies to Japan, to be carried in Japanese vessels.

Preferential colonial shipping policies help the national merchant marine, but do not benefit trade. Insofar as the rates charged by national vessels are higher than those charged by foreign vessels, discriminatory shipping policies offset possible advantages arising from preferential tariffs. The trend is away from further use of the former. Port and tonnage dues and fees for various services, such as bunkering, pilotage, measurements, and sanitary inspection, are occasionally levied on a discriminatory basis. Government subsidies to shipping frequently seek to improve communications between the mother country and the colonies by making the maintenance of adequate shipping services to the colonies a condition of the payment of the subsidy.

### (3) COLONIAL ECONOMIC DEVELOPMENT

The importation of large amounts of capital from metropolitan and foreign countries is the distinctive characteristic of colonial development in modern times. The early development of colonies by settlement and trade did not necessitate large amounts of fixed capital. With the evolution of modern machine technique, however,



## 630 International Trade and Commercial Policy

colonies became ever more dependent economically on the large industrial and commercial centers of Europe, America, and the Orient.

Although the conditions which govern the supply of capital vary from colony to colony and from period to period, colonial investments fall into four broad categories. The first is for settling on the land the nationals of the metropolitan countries, or others. Such investment is in general bound up with the production of colonial foodstuffs or other plantation produce. The second is investment in colonial agriculture and plantations by settlers, joint-stock and private corporations, and governments. Third, there is investment in colonial mineral production. Fourth, there is investment in public utilities and works: roads, railways, power and sanitation facilities, and administrative buildings. These are not always constructed with public money.

In most British, Dutch, and American colonies, the economic role of the state is limited to the supply of essential services. But state intervention in all kinds of industrial matters is increasing; control, at least, of capital investment in colonies is coming more and more under its jurisdiction. In the French colonies, not only has the state opened up the colonies and provided public works on a large scale, but it has also actively encouraged private investment by generous bounties and preferential tariffs. Development is also promoted by granting concessions to chartered companies whose capital is frequently guaranteed by the government; the government may itself become a shareholder.

Policies affecting colonial development are not only important in themselves, but in turn affect trade and trade policy. Treaties which guarantee the open-door in these relations are rare; more frequently the policy is one of restriction through legislative or administrative action. The leading plantations are usually owned and managed by enterprises of the mother country. In the case of nonferrous minerals, there are many instances of exploitation for the benefit of metropolitan interests through colonial policy, although there are instances of the open-door. Under the open-door policy, leading British, British-Dutch, and American oil companies have acquired the right to develop petroleum resources in outlying areas, including important colonies; American and French interests have under this policy

obtained participation with British interests in the exploitation of the oil resources of Iraq. Some of the most important petroleum deposits in the British and Dutch empires, however, have been closed from time to time by legislation.

Investment in colonial enterprises involves greater difficulties for investors of foreign countries than for investors in the metropolitan country. First, the security of investments in foreign colonies is reduced by the risk of exchange fluctuations. Second, colonial securities are seldom quoted on the exchanges outside of the metropolitan country. This geographical remoteness, and economic fluctuations due to internal conditions in foreign countries are serious inconveniences to investors in outside countries. The greatest barrier to investment in colonial securities in the past two decades, however, has been the restrictions placed by foreign countries themselves upon the export of capital.

#### (4) LABOR POLICY

The development of colonial plantations, mines, public works, and other industries requires a regular supply of wage earners with a reasonable continuity of personnel. Ordinarily, there is no such native class in primitive communities, and in tropical colonies white labor is generally out of the question. A wage-earning class has, therefore, to be created. The creation of a wage-earning class encounters substantial difficulties, however, even where population is fairly dense and the pressure on means of subsistence considerable; in colonies with sparse populations, its creation is much more difficult.<sup>10</sup> It has consequently often been necessary to adopt policies of actual or approximate compulsion, in order to get natives to work for the whites.

After the partition of Africa in the latter half of the nineteenth century, naked methods of slavery could no longer be employed, because the Powers pledged themselves to destroy the system. Forced labor, as distinct from outright slavery, has, however, prevailed in many colonies, sometimes as the policy of private com-

<sup>10</sup> In many Asiatic countries, whose populations are increasing and have for generations been accustomed to wage-earning, the labor problem is not that of securing a laboring force; it is the much more familiar problem—to western nations—of avoiding mass unemployment.

## 632 International Trade and Commercial Policy

panies. But curbs upon even these forms of labor recruitment have been initiated by international agreement. Under the Slavery Convention of 1926, all the colonial powers undertook to take every necessary measure to prevent compulsory or forced labor from developing into conditions of slavery.<sup>11</sup> Occasionally, forced labor has been achieved indirectly by levying on the natives a head tax, so large that they must work continuously in order to pay it. Where large areas are alienated for concessions, furthermore, natives who live in the area are virtually compelled to collect the forest products—rubber, palm-kernel, copal—because they are unable to move elsewhere and have practically no alternative but to work for the companies, which can therefore fix their own prices. It is beginning to be realized, however, that the normal incentives to work, viz., the presentation of goods which are relatively cheap in terms of labor, or high wages in pleasant circumstances, have a far more permanent influence upon the labor supply than taxation or compulsion.

Colonial wage policy has been a source of conflict between producing and commercial groups. Producers, seeking low costs, have tried to keep wages low; commercial groups, interested in expanding markets, which in turn rest upon rising standards of living, have urged the payment of higher wages.

### DO COLONIES PAY?

The persistent demands of the Germans for the return of their lost colonies, and the clamor of the Italians and Japanese for greater colonial territories have brought forth during the past twenty years a voluminous discussion of the question, "Do colonies pay?" On the surface, this sounds like a simple question. Closer examination reveals, however, that it is anything but simple. What weight shall be given, for example, to economic factors, to military factors, to political factors, or to factors of national pride? If one were, furthermore, to weigh only the economic considerations, which are the ones that have received greatest emphasis in recent discussions, whose advantage is to be considered, the mother country's, the colony's, or the world's? The many facets of the question obviously make it impos-

<sup>11</sup> Cf. Royal Institute of International Affairs, *The Colonial Problem*, Ch. X, especially pp. 165-170.

sible to draw up any simple and clearly defined balance sheet. All that will be attempted here will be to indicate the main credit and the main debit items, and, since the economic factors are the ones which have received the major attention in recent discussions, the discussion will be restricted to these.

Regardless of the motives of the colonizers—whether political liberty, religious freedom, or personal aggrandizement—the economic effects of colonization have been extremely important. The whole world has profited from the commercial integration of economically undeveloped areas and industrially mature regions, of regions with low agricultural costs and regions of decreasing industrial costs, of regions of widely varying climate and resources. Colonization has brought an increase in the amount and variety and a cheapening of goods for the inhabitants of both the colonizing and colonized countries. To industrial nations, it has been responsible for plentiful supplies of rubber, tin, sugar, vegetable oils, coffee, minerals, various tropical foods, and many other commodities at ever lower prices. The industrial revolution was undoubtedly hastened and intensified in these countries by the existence of large colonial markets greedy for the output of factories. These economic benefits of colonization have not been restricted to the colonizing nations; they have spread to all trading nations.

Colonization has benefited the colonies, too. One writer goes so far as to state that, "Increasingly it is the former (metropolitan powers) who confer and the latter (colonies) who receive the main benefits of their association."<sup>12</sup> Some colonies have derived benefits from preferential tariffs that are vital to their prosperity. Others have profited from the various international restriction-schemes that have been devised for raising the prices of primary products. Such benefits may be considerable in a world in which there is a large excess of productive capacity for the production of most colonial raw materials. It is easy, however, to overvalue these advantages for the colonies. Rarely have international restriction-schemes been of long duration; their boon to producers has consequently been short-lived. Even where restriction-schemes and preferential tariffs have benefited colonial producers, the inhabitants of the colonies

<sup>12</sup> H. D. Henderson, *Colonies and Raw Materials*, The Clarendon Press, Oxford, pp. 28-29.

## 634 International Trade and Commercial Policy

have not always shared in the benefits; it has been the owners in the metropolitan countries who have been the chief beneficiaries. Inhabitants of the colonies have, unquestionably, profited from the efforts of the government of the mother country for the improvement of health, housing, and education and the relief of distress. Colonial deficits, the result largely of expenditures for these social services and public works, have often been met by grants-in-aid from the home government. On the other hand, neo-mercantilist colonial policies have in some instances held down the standard of living of the colonists by retarding colonial industrial development. The role of colonies is, in such instances, still considered to be the furnishing of markets and the production of raw materials for the industries of the mother country. Colonial industrialization can only interfere with this role. The interests of the colonists may also be injured by tariffs or import quotas which deprive them of cheaper imports from foreign nations, by the adoption of low-wage policies, and by currency affiliations with the mother country which handicap their trade with neighboring countries in another currency orbit, although much of their trade would normally be with these countries.

The debate over the colonial question has been little concerned, however, with the advantages of colonization to either the colonies or the world as a whole. The main concern has been, rather, whether the possession of colonies yields net benefits to the metropolitan country. The population, markets, and raw material aspects of colonial ownership will be more fully discussed presently. Before launching out on a discussion of these topics, certain of the more obvious credits and debits of colonial ownership may be briefly mentioned.

On the credit side, certain colonies possess a strategic military value as naval and air bases and as points which give control over routes of communication. The possession of these strategic colonies not only strengthens the possessor, but also prevents their occupation by potential enemies. It was this consideration of military strategy more than anything else which deterred the British and French governments from returning Germany's former colonies. Colonies may also be valuable, from the military standpoint, as a source of manpower during wartime. Both Great Britain and France have made use of colonial troops. Professor Henderson has pointed out, furthermore, that there are definite advantages in having one's

foreign investments in territories under the sovereignty of the mother country. He cites the happier experience of British investors with securities of the Dominions and Colonies than with foreign stocks and bonds.<sup>18</sup> The happier experience of British investors with colonial securities is attributable, however, not specifically to British sovereignty over these investments. The important consideration is relative stability of political and social conditions; foreign investments in as favorable a political and social environment would have fared as well. Investment in one's colonies does, of course, assure wide control over political and social forces.

The first item on the debit side is the cost of acquiring colonies. The acquisition of colonies has frequently involved long and costly wars against major powers. Even the defeat of the rival power, or powers, does not give a nation complete control over the colony; complete control may be attained only when the natives have been subdued, often after many, long years of guerrilla warfare. To the costs of conquest must be added the costs of administration and development. In opening up a colony, large sums must be invested in public works which provided no direct revenue for the colonial treasury, e.g., roads and buildings. Where the costs of administration and social services cannot be met from colonial revenues, the home government is called upon to meet the deficits. Finally, the possession of an overseas empire increases the burden of armaments. A country without colonies is not likely to feel the need for a big navy, unless it has an exposed coastline. But a country with a rich overseas empire generally considers it essential to possess a navy powerful enough to protect its farflung dominions against any aggressive competitors—a navy greater than it would require if it owned no colonies.

#### (1) THE SURPLUS POPULATION ARGUMENT

The plea that colonies offer an outlet for the surplus population of mature nations with teeming populations, without at the same time having these emigrants lost to the fatherland, has been a particularly effective argument in the propaganda of expansionists. Yet it rests upon a weak foundation. The presence or absence of political control has had practically nothing to do with the destination of

<sup>18</sup> *Ibid.*, pp. 11-13.

## 636 International Trade and Commercial Policy

emigrants from Europe during the nineteenth and twentieth centuries. This conclusion is amply supported by statistics collected by the late Grover Clark, an authority on colonial statistics.<sup>14</sup>

The number of emigrants who left all Europe to live permanently in the overseas territories controlled by European governments in the half century up to 1936<sup>15</sup> was extremely small when compared with either the increase in population at home or the migration to regions which were independent. Europe's population in this period increased about 173 millions. The net emigration from Europe was about 19.3 millions. Of these emigrants, only 500,000, or 0.3 per cent of the population increase in Europe and only 2.6 per cent of all permanent emigrants, went to the territories controlled from Europe. About 16.7 millions (86.7 per cent of the total emigrants) migrated to the Americas, 9.3 millions of these to the United States. By 1936, according to Clark, the number of Europeans who had gone to Africa as permanent residents was equal to only six ten-thousandths of Europe's total population. Of the permanent emigrants from Europe, fewer than four out of every ten thousand had gone to European-controlled areas of Asia. In 1913, after thirty years of colonial activity, there were fewer than 20,000 Germans of all occupations in all the German colonies, considerably less than half the number of Germans living in 1930 in the Bronx Borough of New York City. In 1938, far more Italians lived in New York City than in all the Italian colonies combined. Between 1865 and 1924, over 17,000 more *Hollanders entered* the Netherlands from the Dutch colonies than left for these colonies, even though the Netherlands is one of the most thickly settled countries in the world. Although Japan's population increased eight millions between 1925 and 1933, the total net emigration from Japan to all her colonies in the same period was less than 294,000, and the net emigration to all the world outside of Japan proper was only about 350,000.

The reluctance of emigrants from European and other countries to emigrate to their own colonies is not difficult to explain. People who leave the land of their birth permanently do so because they are not content with their lot at home; they leave home to better

<sup>14</sup> See his *A Place in the Sun* (1936) and *The Balance Sheets of Imperialism* (1936).

<sup>15</sup> This statement does not include the British Dominions.

themselves. They seek better opportunities, more freedom, or easier conditions of life. These they cannot find in backward places where living conditions are primitive, labor returns meager, and disease and danger lurk uncomfortably near. Colonies are already fairly densely peopled in relation to their natural resources and economic opportunities. Most colonial areas in the world today, moreover, are in the tropics, and their climatic conditions are unsuitable for outdoor labor by people of European stock. It is to countries where there are great and relatively easy opportunities for advancement, such as the United States, Canada, Argentina, Brazil, and Australia, that dissatisfied peoples of Europe have chosen to go.<sup>16</sup>

For countries where a rapidly increasing population presses heavily upon the means of subsistence, two remedies offer greater promise of relief than do colonies: industrialization and birth control. Industrialization has made it possible for England and Wales, which in 1800 could feed a population of only 9,100,000, to support a population of 32,000,000 in 1900 and one of 41,600,000 in 1940. It is significant, too, that the rising levels of income which have accompanied industrialization in western countries have brought sharply declining birth rates in those countries. It is ironical that those nations which have been most vehement in their demands for colonies to relieve an intolerable pressure of population have at the same time tried to suppress the dissemination of information regarding birth control and to encourage marriage and the raising of large families by the offer of a wide variety of special privileges and subsidies.

## (2) THE RAW MATERIALS ARGUMENT

Fully as important as the population argument in the imperialist's arsenal of propaganda has been the raw materials argument. This argument contends that a nation's security demands the possession

<sup>16</sup> During the decades prior to 1914, large numbers of Europeans migrated to the New World; thereafter, this stream shrank to a mere trickle. The shrinkage was caused by two factors. Restrictive immigration laws were passed by states in the Americas and Australia, which did not wish to have their troublesome social problems made worse by the arrival in wholesale numbers of new employment-seeking immigrants. The totalitarian states of Europe, on the other hand, curbed the emigration of their subjects to foreign areas, preferring, for military and nationalistic reasons, to keep their citizens at home or else shunt them to their own colonies.



## 638 International Trade and Commercial Policy

of colonies in order to ensure access to raw materials in time of war and, further, that such control over sources of raw materials gives a nation substantial advantages in time of peace. Such an argument has little more foundation than the one based on population.

Access to the sources of raw materials in wartime depends not on the presence or absence of political control over such sources, but on the ability to keep open the lines of communication with these sources. Inasmuch as many vital materials must, for most nations, be transported over sea routes, the unimpeded inward flow of these materials depends upon mastery of the seas. If a nation possesses naval supremacy, however, there will be little trouble in obtaining vital supplies even though a nation does not have political control over the territories in which they are produced, unless neutral producing states apply rigid "neutrality embargoes." But all nations cannot simultaneously have naval supremacy. Even the British navy was able to maintain the flow of supplies into the home country during 1917-1918 and 1940-1942 only with the help of allied navies.

The strategic factor has assumed perhaps greater importance since the distinction has been made between economic and military sanctions. If economic sanctions alone are applied against an aggressor nation, the aggressor will not be cut off from colonial supplies even if he does not control the sea lanes. How helpful colonial supplies alone may be for most colonial powers is, however, open to question. A nation may secure through colonies self-sufficiency in one, two, or a few raw materials; it is highly improbable that it will secure self-sufficiency in all. The colonial and mandated areas are much less important as sources of raw materials than is commonly supposed. In foodstuffs, colonial production is of appreciable importance (greater than 20 per cent of world production) only in cocoa, tea, cane sugar, and bananas. In materials, colonial production exceeds 20 per cent of the world production only in copper, tin, rubber, graphite, phosphates, and vegetable oils; notable by their absence are such basic materials as iron, coal, and petroleum and such basic foods as cereals and meats.<sup>17</sup> France, before the

<sup>17</sup> In some instances, a small percentage of world production may be sufficient to satisfy a nation's needs for a certain commodity. See the tables of colonial production at the end of this chapter.

second World War, imported approximately two-thirds of her raw materials. Only one-tenth of these came from her colonies, however—after 50 years of empire building. The chief suppliers of the most important foods and raw materials are sovereign states, not colonies.

In peacetime, there is little danger that any nation will be unable to secure the raw materials which it wants and which it is prepared to pay for. The peacetime problem of raw materials is not a problem of accessibility, but rather one of excess productive capacity. Raw materials recognize no national flag; they are sold to the highest bidder regardless of nationality. They follow the laws of supply and demand, of distance and transportation costs. Malayan and Dutch East Indian natural rubber goes to the United States, graphite from French Madagascar to England, not to France, cobalt and nickel from French New Caledonia to Belgium. Only by differential export taxes or embargoes can this natural tendency ordinarily be overruled. But such measures are rarely employed, particularly where monopoly is absent and there is a world excess capacity.

If a monopoly of some colonial raw material can be established, it may be exploited for the profit of business men in the mother country. The British Stevenson rubber restriction-scheme of the early 1920's provides an example of such monopoly exploitation; it also demonstrates the impracticability of striving for such monopoly profits. High monopoly prices encourage the search for synthetic substitutes (as in the cases of rubber, nitrates, camphor, and quinine) and the development of new sources of supply (as in the cases of rubber and nickel). Almost without exception in the long list of minerals vital to modern industry, the leading producing countries produced a substantially smaller proportion of the world's total in 1933 than they did ten years earlier.

Can a nation obtain raw materials more cheaply from its own colonies than from foreign countries? Whether raw materials are obtained from colonies or from foreign nations, they must be paid for. They can be obtained more cheaply from areas under a country's political control only if they can be produced more cheaply there. The costs of producing any article are equal to the sum of the products of the quantities of productive factors used multiplied by their prices. Unless colonial natural resources are richer, or more accessible, than those of rival producing areas, therefore, primary

## 640 International Trade and Commercial Policy

products can be produced more cheaply in colonies than they can in other places only if the productive factors are more lowly rewarded in colonies than in other areas. Colonial workers and landowners can, to be sure, be exploited, and in some cases have been; but that is a short-sighted policy. In most instances, a nation can acquire needed raw materials from established producers in foreign lands much more cheaply than she can if she seeks to build up new sources of supply through the acquisition of colonies.

The prices of raw materials are important for the national economy. If national industries have to pay higher prices for raw materials than do producers in other nations, they will be unable to compete in world markets. The domestic market can, of course, be protected. But protection of the home market in order to subsidize inefficient colonial production must be paid for by the inhabitants of the metropolitan country in lowered living standards.

One of Germany's principal arguments for demanding colonies was that she found it impossible to acquire the necessary foreign exchange to pay for the raw materials she needed, and consequently required sources of raw materials under her own political control. This argument touches one of the basic problems of raw materials. It is idle to declare that raw materials are freely available for all who can pay for them, when there are some countries which do not possess sufficient gold or, because of tariffs, import quotas, or exchange restrictions in other countries, cannot acquire the means of payment. So long as there are obstacles to international trade, it must always be somewhat easier to purchase materials within one's own currency area than outside it. The importance of colonies in this respect can, however, be exaggerated.

Where the mother country's own currency circulates freely in the colony, individuals in the mother country face no foreign exchange problem when they purchase colonial products. Where the mother country's currency does not circulate freely in the colony, however, colonial products must be paid for in foreign exchange, which can be acquired only by the export of goods, services, or gold, or by the raising of foreign credits. In periods of severe currency fluctuation, the mother country may derive some benefit from her political control even in the latter case, since the colonial currency

is usually stabilized in terms of the currency of the mother country.<sup>18</sup> Colonies may at times be a source of foreign exchange to the sovereign state. During the recent war, the British government compelled the government of India to surrender to her large dollar balances which India had acquired by wartime exports to the United States.<sup>19</sup>

In summary, there are just two reasons for a raw materials problem in peacetime: monopoly, and economic nationalism. International restriction-schemes may be used for the exploitation of consumers, while trade barriers make it difficult for potential purchasers to obtain the means of payment. The strategic importance of raw materials in wartime makes them centers of conflict in the continuous struggle for power forced upon nations by the ever-present risk of war.

### (3) "TRADE FOLLOWS THE FLAG"

"What our great industries lack is markets." Thus did Jules Ferry justify French imperialism before the world in the late nineteenth century. For markets, he annexed colonies. Today, expansionists place the markets argument high among their arguments for colonies. "Trade follows the flag" is still a popular slogan.

It cannot be denied that political control gives producers in the metropolitan country advantages in colonial markets. During the five-year period 1930-1934, for example, 80 per cent of the imports into Algeria and 54 per cent of the imports into the other French colonies came from France, 80.2 per cent of the imports into the Japanese colonies came from Japan, 59 per cent of the imports into

<sup>18</sup> Of course, the mother country may, as a result of stabilization, be denied a bargain in colonial products at times when an independent colonial currency would have depreciated.

<sup>19</sup> However great the degree of colonial political autonomy, financial policy is not entirely determined locally. Colonial financial policy is influenced by the close connection between the colonial central bank (where one exists), upon which the colonial government has to depend for day to day advances, and the financial center of the empire, where the bank usually has an office working in collaboration with the imperial central bank. The maintenance of high values on the currencies of the Netherlands Indies and French Indo-China during the 1930's made the position of both countries, which trade largely with Eastern countries, very difficult; not until the French franc and the Dutch guilder underwent devaluation in Paris and The Hague, respectively, could the situation be eased.

## 642 International Trade and Commercial Policy

the Philippines came from the United States, and 47.3 per cent of the imports into the Belgian Congo came from Belgium. That political control is not the only factor which determines the origin of colonial imports, however, is shown by the relatively small proportion of their colonial markets supplied by British and Dutch producers. Imports into British colonies and protectorates from the United Kingdom constituted only 23.6 per cent of British colonial imports in this same period, and imports into the Netherlands Indies from the Netherlands amounted to only 15 per cent of the total imports of the Dutch colonies.<sup>20</sup> Geographical proximity also is an important factor in determining the source of imports.

The most important advantage which political control gives for the development of markets in the colonies for home-country products lies in the opportunity to employ colonial preferential import duties, which before the war were widely used. Fully as effective as preferential duties in limiting the sales of foreigners in colonial markets, although less extensively employed, are colonial import quotas. When Japanese cotton textiles began rapidly to displace British goods in the Indian market in the early 1930's, the British government was able to preserve a segment of the valuable Indian market for Lancashire producers by placing a limit upon imports of Japanese cottons.

Even though the sovereign state adheres to the open-door policy, political control yields certain less tangible advantages which tend to turn the channels of colonial trade in the direction of the mother country. Exporters in the mother country are favored by official use of the language, systems of weights and measures, legal systems, and business customs of the suzerain. Another advantage which producers in the metropolitan country possess in the markets of the colonies is to be found in the usually close affiliations which exist between the colonial currency and banking system and those of the mother country. Finally, large purchases, both official and unofficial, are made in the mother country by military and civil servants in the colonies, who tend to turn to the sources they know in the home country.

Although the volume of colonial trade is impressive, no colonial

<sup>20</sup> See the Royal Institute of International Affairs, *The Colonial Problem*, pp. 412-413.

power transacts as much as one-fourth of its total interregional trade with its colonies.<sup>21</sup> It may be questioned, furthermore, just how profitable this colonial trade actually is to the suzerain. Grover Clark has pointed out that all of Italy's trade, import and export, with her colonies from 1894 to 1932 amounted to only 5,561 million lira, whereas in the twenty years 1913-1932 alone Italy spent on her colonies 6,856 million lire—1,300 million lire more than the value of all her colonial trade in forty years.<sup>22</sup> Germany's trade with all her colonies during the twenty years 1894-1913 was 972 million marks. In the same period, her colonial expenses were 1,002 million marks, not including those for Kiaochow. Japan has spent directly on getting and keeping her colonies about 2,860 million yen. This is 18.4 per cent of all her trade with all her colonies from the time of her first acquisition of overseas territories. By apportioning to colonial defense a percentage of Japan's military costs equal to the percentage which her colonial trade bore to her total external trade, on the grounds that a substantial part of the expense of creating and maintaining her large army and navy was due directly to her acquisition and possession of colonies, and by adding this figure to her direct colonial expenses, Clark found that Japan's total expenses exceeded one-third of her total colonial trade. The percentages, similarly calculated, for France and the United Kingdom were 21.1 and 7.2 respectively.<sup>23</sup> Obviously, Italy and Germany went deeply into the red on their colonial ventures. It is doubtful if Japan, France, and the United Kingdom realized on their colonial trade profit margins sufficient fully to cover their colonial expenses.

No country, furthermore, gets all its trade with its colonies because it has political control. The fact that all colonies trade with countries other than the one in control demonstrates that the con-

<sup>21</sup> Even since the Ottawa Agreements of 1932, only a little more than one-third of the United Kingdom's total external trade has been with the rest of the Empire (up to the outbreak of war); the share with the British countries directly under London's control has been only 15 per cent of the total.

<sup>22</sup> See *The Balance Sheets of Imperialism*, pp. 11-13. Mussolini is reported to have spent 10,000 million lire in the first six months of his Ethiopian campaign.

<sup>23</sup> French figures are for the period 1894-1934, but exclude the years 1918-1921. If both trade and expenses are excluded for the World War I years, the percentage becomes 16.3. By the inclusion of the first World War expenses, the United Kingdom figure is raised to 21.6 per cent.

## 644 International Trade and Commercial Policy

trolling country would probably get a fair amount of the trade of the regions which make up its colonies even if it did not have control. It is true that before 1939 every metropolitan power did more business with its colonies than it did half a century earlier; but so did other countries do more business with these same colonies. In the case of France and Japan, colonial trade became relatively more important, largely because of high empire preferences. The share which territories controlled from London had in the trade of the United Kingdom, however, has decreased in the past fifty years, while that of the self-governing Dominions has increased.

Ownership of a colony enables the mother country to enjoy, as a rule, a somewhat larger share of the colonial market than would otherwise be hers, but it does not invariably enable her to monopolize that market. In colonies, as elsewhere, trade is governed by price, quality, and availability. In the seventeenth century, the British and Dutch carried on much trade with the Spanish colonies. In the seventeenth and eighteenth centuries, much of the trade of Britain's American colonies was transacted with France's West Indian colonies, despite the restrictions of the Navigation Acts. In the 1920's and 1930's, British products were being supplanted by Japanese products in India, the Malay peninsula, Tanganyika, and Kenya.

Industries in the home country that produce articles which can be sold in large quantities to colonial populations, such as iron and cotton goods, benefit from colonies. Preferential entry into colonial markets not only assures such industries a broader market, but may also permit industries which have not kept pace with foreign competitors to survive. To the general taxpayer in the mother country, however, colonies mean an added economic burden, a burden which appears in most cases to more than counterbalance the gains of the special interests. Colonial preference penalizes the colonists, and rarely does the preference accorded colonial products in the markets of the mother country compensate for such costly favors to the suzerain.

### (4) CONCLUSION

The so-called "colonial problem" is not a mere problem of colonies. It is far broader. The demand for colonies springs, on the economic side, from two sources: the fear of war, and restrictionism. As

long as national security is endangered by the constant threat of war, sovereign states will seek to strengthen their war potential by bringing under their political control an ever wider variety of raw materials, irrational as this may seem when one considers the virtual impossibility of attaining self-sufficiency and the inaccessibility of colonial products in wartime, except where lines of communication can be kept open. As long as export markets are restricted by the imposition of protective tariffs, import quotas, and exchange controls, nations will strive to acquire territories that can be placed under their exclusive control, into which they may pour their surplus products without artificial hindrance and from which they may purchase primary products within their own monetary orbit. The removal, or at least the lowering, of trade barriers will go far to solve both difficulties. It will provide the markets for the surplus products, and it will produce the foreign exchange to buy raw materials anywhere in the world. But the removal of trade barriers is no mere colonial problem; it is a world problem. The richest markets for manufactured goods are, after all, not backward countries, with their low levels of income, but other industrial nations. It is the trade barriers of these latter, not the foreign ownership of colonies, which frustrate trade. In the absence of foreign exchange restrictions, exports, wherever sold, would yield the foreign exchange needed to purchase required materials.

There is an additional economic source of possible dissatisfaction with the current distribution of colonies, viz., the monopolistic exploitation of raw materials where they occur in a limited geographical area, or where they come under international restriction-schemes. Rubber and tin are examples. The control of any vital material imposes upon the controllers a trust, a trust to make available to the world ample supplies of the material at prices which yield to producers no more than reasonable profits. Again, this is much broader than a question of colonies. Also, the danger is less than that of trade restrictionism or war. For synthetics and new sources of supply are ever ready to rise to taunt the would-be monopolists. Yet governments which may seek to placate dissatisfied economic groups within their borders by forming international cartels, at the same time that they endeavor to preserve world peace, should beware of abusing such devices.

Finally, the true bases of the demand for colonies are not always



## 646 International Trade and Commercial Policy

of an economic nature. The economic reasons have been shouted to the heavens because they seem to contain a modicum of rationality. When the issue is squarely faced, however, it will be found that the

### STATISTICAL APPENDIX

TABLE 10. Colonial Production of Industrial Raw Materials as a Percentage of Total World Production<sup>a</sup>

Raw Material	Total	Dependencies of								
		Great Britain	France	Belgium	Italy	Portugal	Spain	Netherlands	Japan	Mandates
Antimony	0.7		0.5				0.2			
Bauxite	13.1	5.2						7.9		
Chrome ore	12.3		12.3							
Copper <sup>b</sup>	21.3	12.7		8.6						
Iron ore	3.4	1.2	1.5				0.3		0.4	
Manganese ore	13.7	13.1	0.2					0.4		
Nickel	9.0		9.0							
Tin <sup>b</sup>	56.9	35.4	1.0	3.7			16.8			
Tungsten ore	15.6	11.2	1.9						2.5	
Zinc <sup>b</sup>	1.9	1.4	0.5							
Petroleum	3.7	0.8						2.9		
Rubber, natural	96.1	56.7	2.0					37.4		
Graphite	46.0	10.5	7.5						28.0	
Phosphates	52.0	3.4	41.9					1.1		5.6
Pyrites	3.4	3.2	0.2							
Gold	6.4	1.8	0.7	1.4				0.3	1.7	0.5
Silver	1.3	0.4 <sup>c</sup>						0.5	0.4	
Cotton	2.5	1.5		0.4					0.5	0.1
Wool	2.3	0.2	2.0							0.1
Silk	3.1								2.9	0.2
Hemp	6.2								6.0	0.2
Copra	64.4	24.6 <sup>d</sup>	1.8			1.9		30.5		5.6
Cottonseed	2.6	1.7		0.2					0.6	0.1
Olive oil	12.9		11.2		0.4					1.3
Groundnuts	28.5	6.0	13.7	1.2		0.9		3.8	2.0	0.9
Palm oil	98.8	48.4	7.1	13.9		2.3		22.0		5.1
Sesame	8.0	3.9	0.6	0.8		0.3		0.4 <sup>e</sup>	0.3	1.2

Source: The Royal Institute of International Affairs, *Raw Materials and Colonies*, 1936, facing p. 26.

<sup>a</sup> The table covers all industrial raw materials of which Colonial or Mandated Territories together produce as much as one per cent or more of the world total, with the exception of vanadium and sial. Figures are in some cases for the year 1933, for others 1934.

<sup>b</sup> Metal content of ores mined.

<sup>c</sup> Including 0.3 per cent from South-West Africa.

<sup>d</sup> Including 0.6 per cent from Papua.

<sup>e</sup> Exports.

real reasons are more often political; the economic reasons are a mere rationalization. Colonies are wanted because they are of strategic value, because they fulfill a heaven-given obligation to educate and rule other peoples, or because they satisfy the craving for "a place in the sun."

TABLE 11. Colonial Production of Principal Foodstuffs as a Percentage of World Production, 1933

Foodstuffs	Total	Dependencies of									
		Great Britain	France	The Netherlands	United States	Japan	Portugal	Spain	Italy	Belgium	Mandates
Wheat	1.9		1.4			0.2					0.3
Beef <sup>a</sup>	1.5		1.5								
Pork <sup>a</sup>	1.0		1.0								
Butter <sup>a</sup>	0.7	0.2									0.5
Cane sugar	35.9	18.9	1.4	4.3	6.4	4.4	0.2				0.3
Citrus fruits <sup>a</sup>	9.7	7.8	1.2		0.4	0.3					
Bananas <sup>a</sup>	30.2	11.5	2.5	0.1	0.1	6.6	0.4	8.4	0.6		
Coffee	7.6	1.1	0.7	4.4	0.2		0.4			0.3	0.5
Tea	48.0	25.7	0.2	19.7		2.4					
Cocoa	78.7	56.3	6.8	0.2			1.8	1.8		0.2	6.6
Tobacco	4.8	0.3	1.6	2.5	0.3						0.1
Olive oil	17.8	2.4	10.7						0.5		4.2

Source: *Raw Materials and Colonies*, Appendix VI, Table 2.

<sup>a</sup> Net export

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## *International Investment*

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### THE SIGNIFICANCE OF INTERNATIONAL INVESTMENT

International investment played an essential part in the world's economic development during much of the nineteenth and the early years of the twentieth centuries. In this period international trade grew rapidly, and one of the most striking features of this growth was the development of a complementary and mutually advantageous trade between the old countries of Europe and the newer countries of the western hemisphere. International investment was indispensable to this expansion of world trade. The economic development of the newer countries required large capital expenditures for the construction of railways, the sinking of mines, the building of towns, the erection of factories, the creation of public utilities, and the development of agriculture. The pace of the development would have been greatly retarded if these young countries had been limited to their own resources for the capital equipment and savings necessary for these purposes.

This intercourse was highly beneficial to both parties. It enabled the peoples of the new countries to share, to an otherwise impossible degree, in the benefits of the series of mechanical inventions which were adding immensely to the productive powers of manufacturing industry. It met an even more vital need of the peoples of Europe, particularly of Great Britain. By bringing into cultivation the virgin lands of the New World, it supplied the inhabitants of western Europe with the means of obtaining the abundant foodstuffs and raw materials that their rapidly growing industrial life required. At the same time, expanding markets were provided for

## 650 International Trade and Commercial Policy

the ever-increasing output of manufactured goods from British and European factories. It was thus through the development of international trade, which in turn rested upon the export of capital, that the potentialities of the industrial revolution were translated into a steady and substantial improvement in the standard of living. Although important sums of European capital were invested from time to time in loans to foreign governments, which devoted the proceeds chiefly to military purposes, investments associated with the development of complementary trade were so important that they came to be regarded as the characteristic type of international investment. The encouragement of international investment consequently became a cardinal policy of governments and business in the late nineteenth century, both in lending and in borrowing countries. The prestige won by the gold standard in this period rested, to a considerable degree, upon its ability to facilitate international investment by ensuring exchange stability, an important condition of international investment.

### THE INTERNATIONAL LENDERS

The foremost exporter of capital before World War I was Great Britain, the cradle of modern industrialism. By 1914 private British capital to the value of about twenty billion dollars had been invested abroad, and British investments were increasing at the rate of nearly one billion dollars a year. French foreign investments in the same year amounted to nine billion dollars, and the annual flow of French capital abroad was roughly 250 million dollars. The third great international lender was Germany, with foreign investments of six billion dollars in 1914 and an annual increase of 150 million dollars or more. Other lending nations in this period were Belgium, the Netherlands, Switzerland, and Italy. During the prewar decades there flowed from the nations of western Europe to the undeveloped regions of the earth a large stream of capital; from the backward and capital-hungry regions there flowed back to Europe a steady stream of dividends, interest payments, premiums, and commissions to enrich the lenders as a result of the increased productivity of the borrowers. Throughout most of the nineteenth century the United States was a borrower; but by the end of the century she had begun to export capital, largely to Canada and Central

America but also, to a smaller extent, to South America and China. Nevertheless, in 1914 she was a net debtor; she owed abroad something like six billion dollars, while her own foreign investments amounted to only two and a half billion dollars.

The first World War wrought profound changes in the economic prosperity of different countries, and in the balance of international indebtedness. The United States was transformed from the greatest debtor to the second greatest creditor country in the world, exclusive of government war debts. Her nationals had acquired a large proportion of the American securities previously held by foreigners; her government was the creditor to the governments of her European allies for the enormous sums lent them. A net debtor status of approximately \$3,700,000,000 in 1914 was transformed into a net creditor status, exclusive of intergovernmental debts, of the same amount in 1919; the United States government had advanced to European governments an additional \$10,338,000,000. Her international trading position and the current accounts in her international balance of payments, furthermore, were markedly strengthened. American industry had acquired a firm grip on the world market for many industrial products, especially the newer products such as the automobile, while the decline in the productivity of European agriculture increased the world demand for American agricultural products.

The condition of the belligerent countries of Europe presented a sharp contrast. France, though victorious in the war, emerged in an economically weakened condition. Germany came forth stripped of her capital assets overseas and her mercantile marine, with both her industrial and her agricultural plant impaired. England had been forced to sell a large fraction of her international investments during the war, although she still held substantial claims on the outside world, and some of her industries found it impossible to recapture the ground in world markets that they had lost to foreign rivals during the war. Thus the three major prewar lending nations emerged from the war with a weakened capital position, a less favorable balance of payments, and a reduced capacity to lend. To the United States, growing rapidly in wealth and prosperity, and with a large and growing margin of savings, was assigned the role of the major lending nation.

## 652 International Trade and Commercial Policy

In the period 1919-1930 the United States provided to foreigners \$11,600,000,000 by way of subscriptions to new foreign issues and new direct investments abroad, an annual average of about \$965,000,000.<sup>1</sup> American short-term assets abroad increased during the same period by somewhat more than one billion dollars. This outflow was offset in part by amortizations and retirements of about \$3,300,000,000 and by net purchases by foreigners of foreign securities in an indeterminable, but relatively small, amount. The country's net creditor position was increased from \$3,700,000,000 in 1919 to \$8,800,000,000 in 1930. A summary of the international investment position of the United States in 1919, 1930, 1933, and 1939 is presented in Table 12.

Several factors contributed to the unprecedented outflow of American capital in the decade following the signing of the Armistice. First, the Liberty Loan campaigns had built up a wide public market for securities in the United States, and the publicly offered foreign loans of the war period had begun to acquaint the investing public with foreign bonds. Second, Western Europe, which before the war had been an exporter of capital, was, in the early postwar years, in dire need of outside funds to purchase immediate necessities, to stabilize currencies, and to make capital improvements of both a private and public nature. Third, business activity in the United States was on a high level during practically the entire period, and bank credit underwent a tremendous expansion. Fourth, the restoration of the gold standard and the stabilization of currencies made both lenders and borrowers more willing to enter into foreign financial contracts. Fifth, the capital markets of the European creditor countries were closed, from time to time, to foreign issues; also, the cost of borrowing to non-Empire countries was higher in London than in New York. Finally, the high yields obtainable on foreign bonds made them unusually attractive to the American investing public; and the prospect of commissions much higher than those obtainable on domestic issues, together with the necessity for a continuous flow of new securities to keep large staffs of bond salesmen employed, caused American investment banking firms to

<sup>1</sup> Direct investments abroad are defined and discussed below. The statistical estimates are taken from the United States Department of Commerce, *The United States in the World Economy*, pp. 89-123.

compete keenly for this lucrative business, and many times to persuade prospective borrowers to borrow more than they needed.

Before the first World War, the bulk of American capital exports had gone to the countries which border the Caribbean Sea and

TABLE 12. International Investment Position of the United States in Selected Years from 1919 to 1939 (Excluding Inter-Governmental War Debts)  
(In billions of dollars)

Item	End of Year			
	1919	1930	1933	1939
United States Investments Abroad:				
Long-term:				
Direct	3.9	8.0	7.8	7.0
Portfolio	2.6	7.2	6.0	3.8
Total long-term	6.5	15.2	13.8	10.8
Total short-term	.5	2.0	1.1	.6
Total long- and short-term	7.0	17.2	14.9	11.4
Foreign Investments in the United States:				
Long-term:				
Direct	.9	1.4 <sup>a</sup>	1.8 <sup>b</sup>	2.0
Portfolio <sup>c</sup>	1.6	4.9 <sup>a</sup>	3.1 <sup>b</sup>	4.3
Total long-term	2.5	5.7	4.9	6.3
Total short-term	.8	2.7	.5	3.3
Total long- and short-term	3.3	8.4	5.4	9.6
Net Creditor Position of the United States:				
On long-term account	4.0	9.5	8.9	4.5
On short-term account	-.3 <sup>d</sup>	-.7 <sup>d</sup>	.6	-2.7 <sup>d</sup>
On long- and short-term account	3.7	8.8	9.5	1.8

Source: U.S. Department of Commerce, *The United States in the World Economy*, p. 123.  
<sup>a</sup> 1929 data. <sup>b</sup> 1934 data. <sup>c</sup> Includes miscellaneous investments. <sup>d</sup> Net debtor position.

to Canada. Although these regions continued to borrow heavily in this country after the war, the region which received the largest amount of American capital was Europe, and the largest European borrower was Germany. South American countries, too, became major borrowers. How the geographical distribution of American foreign investments was altered between the end of 1914 and the



## 654 International Trade and Commercial Policy

end of 1929 is shown by the estimates of Cleona Lewis which are presented in Table 13.

After 1929 the conditions of American foreign lending became less propitious, and American capital export declined precipitously. Rising interest rates, caused by the speculative boom of 1928-1929,

TABLE 13. Geographical Distribution of American Investments Abroad in 1914 and 1929

Region	Volume of Investments (000,000 omitted)		Percentage of Total	
	1914	1929	1914	1929
Europe	\$691.8	\$4600.5	19.7	27.0
Canada and Newfoundland	367.2	3660.2	24.7	21.5
Cuba and West Indies	336.3	1153.9	9.6	6.8
Mexico	853.5	975.2	24.2	5.8
Central America	93.2	286.3	2.6	1.7
South America	365.7	3013.8	10.4	17.8
Africa	13.2	119.2	.4	.7
Asia	245.9	1040.4	7.0	6.0
Oceania	17.0	403.0	.5	2.4
International, including banking	30.0	140.1	.9	.8
Total long-term	\$3513.8	\$15,392.6	100.0	90.5
Short-term	—	1,617.0	—	9.5
All foreign investments	\$3513.8	\$17,009.6	100.0	100.0

Source: Cleona Lewis, *America's Stake in International Investments*, The Brookings Institution, 1938, p. 606.

reacted unfavorably on the bond market in the United States, while declining business activity abroad depressed interest rates in foreign money markets. The decline in foreign security underwriting was offset in part, however, by public security offerings of American corporations for purposes of foreign expansion and by the extension of short-term credits by American banks. As depression deepened, defaults by foreign debtors, political instability abroad, and foreign exchange controls multiplied, and combined to bring to a virtual standstill American foreign lending. Between 1930 and 1939, American long-term investments abroad declined by \$4,400,000,000 and short-term credits by \$1,400,000,000.

So great a reversal in the international flow of capital set in after 1933 that the United States became a net importer of capital. Defaults by foreign debtors and foreign exchange controls—which prevented the payment of interest in dollars but permitted such payment in foreign currencies—depressed the prices of foreign bonds in the American market and made it possible for foreign debtors to purchase their bonds here at substantial discounts. Foreign investors also bought large amounts of American securities because the yields therefrom were higher than from comparable foreign securities, and foreign institutional investors purchased American securities in order to obtain greater diversification of their portfolios. The devaluation of the dollar in 1934, too, made American and foreign dollar securities especially attractive to foreigners.

The largest movement of capital toward the United States, however, was in the form of short-term funds. This was induced by political and economic instability abroad. Fears of currency depreciation, high taxes, and government restrictions caused capital to seek safety in the United States, where money was regarded as more secure. Much of this foreign capital was of a short-term, liquid character, dubbed “hot money,” that might be suddenly withdrawn. The net creditor position of the United States that had reached a high of \$9,500,000,000 in 1933 had by 1939 been drastically reduced to a mere \$1,800,000,000. The unhappy results of his venture into foreign lending during the 1920's has made the American investor extremely wary of foreign securities.

#### THE NATURE OF CAPITAL EXPORT

What, exactly, is meant by the term, “export of capital”? The use of the term, even by some economists, has involved a certain amount of confusion. This confusion has arisen in part from the different meanings commonly given to the word “capital,” and in part from failure to distinguish carefully just what it is that is transferred when capital is exported. The term “capital” does not here refer to capital goods, i.e., machinery, locomotives, ships, and the like, although the export of capital may, and frequently does, take the form of capital goods. Nor does the term “capital” refer to physical currency. Currency, with the lone exception of gold currency, seldom crosses national boundaries because the paper currency of one country

## 656 International Trade and Commercial Policy

would not be current in a foreign country, although in periods of currency instability United States paper currency has been exported in sizable amounts for hoarding in foreign countries.

An export of capital involves two separate and distinct transactions: a transfer of purchasing power within the lending country, and an export of goods, services, or gold. What actually takes place when capital is exported is that residents of one country place a part of their money incomes at the disposal of residents of another country; these transfers of money income result in no immediate return payments, but are made with the intent of receiving in return adequate payment at some future time. In other words, persons in the lending country transfer purchasing power in their own country, in terms of their own currency, to residents of another country. This transfer of purchasing power enables the borrowers to purchase goods, services, or gold in the lending country. By the transfer of purchasing power, the lending country surrenders to the borrowers command over a portion of its real income. In return for this surrender of purchasing power to the borrowers, the lenders will acquire bonds, stocks, or titles to property in the borrowing country.

Carl Iversen defines that which is exported in the case of capital export as "free capital disposal." This term emphasizes the point that a nation has available for lending only that part of its income which it chooses not to consume immediately. By abstaining from the immediate consumption of their whole income, people supply waiting, which makes possible the adoption of more roundabout "capitalistic" methods of production.<sup>2</sup> The supply of "free capital disposal," i.e., loanable funds available for investment, during a given period of time comes from four sources: (1) the new savings of the period; (2) the amortization of the period, i.e., the quota of capital disposal previously embodied in capital goods but now set free for reinvestment or consumption; (3) new purchasing power created by the banks; and (4) borrowing from abroad.

Capital export need not necessarily, however, lead to more roundabout processes of production abroad. The purchasing power acquired in the lending country by the borrowers may be spent on consumers' goods or services; or it may be squandered on court dis-

<sup>2</sup> *Aspects of the Theory of International Capital Movements*, pp. 19-30.

play, magnificent, but unproductive, public buildings, or war. But, where capital export fails to increase the productive powers of the borrowing country and its capacity to export, the chances that the lenders will secure the eventual repayment of their loans will be considerably lessened.

The term "export of capital" is frequently applied to the mere transfer of title to purchasing power. Foreigners who have sold an issue of bonds in a given country may, for example, choose not to spend the proceeds from the sale of the bonds immediately, but may prefer instead to leave their funds temporarily on deposit in banks in the lending country. The lending country has in this case made an export of long-term capital, even though it has not exported goods, services, or gold. But this export of long-term capital has been counterbalanced by an equal import of short-term capital—the increase in foreign-owned bank balances in the lending country. Not until the foreigners have spent their balances in the lending country for goods, services, or gold will a *net* export of capital from the lending country have taken place. When the foreign borrowers, or persons to whom they may have sold their funds in the lending country, eventually import from the lending country goods or services, they will pay for them with the bank balances which they had previously built up in the lending country from the proceeds of the loan. The reacquisition of these balances by nationals of the lending country constitutes an export of short-term capital, and is a *net* export of capital, for then it is matched by an export of goods.<sup>3</sup>

When the borrowers spend their borrowed funds for goods, services, or gold as soon as they secure the funds from the sale of their securities in the lending country, an immediate net export of capital

<sup>3</sup> The dependence of *net* capital exports upon the export of goods, services, or gold has led Dr. Harry D. White to define the export of capital as "the transfer of purchasing power, *whether in terms of goods, services, or specie*, made by residents of one country to residents of another country, when such transfers result in no immediate payments, and when they are made with the intent of receiving in return adequate payment at some time in the future." (*Italics the author's.*) Dr. White also states that the term "is frequently applied also to transfer of *title* to purchasing power. . . ." and that "this transfer of title to purchasing power constitutes in almost all cases of capital movements the necessary first step." *The French International Accounts, 1880-1913*, Harvard University Press, 1933, p. 86.

## 658 International Trade and Commercial Policy

occurs. But the transfer of purchasing power that is effected by an international loan may not be converted into a transfer of goods or services until weeks, months, or even years have passed. The borrowers may choose to surrender their funds in the lending country to banks in their own country in exchange for local currency, and the banks in the borrowing country may use the foreign funds thus acquired to build up their own balances in the lending country.

An export of capital obviously affects both sides of the balance of payments. To the lending country, the loan appears as an import, and the goods, services, or gold sent to the borrowing country as an export. If no goods are exported immediately, the increase in foreign-owned, domestic bank balances will appear as an export. To the borrowing country, the loan appears as an export, and the goods, services, or gold acquired as an import. If no goods are imported immediately, the increase in foreign bank balances will appear as an import.

### INCENTIVES TO FOREIGN LENDING

The chief incentive for foreign investment is yield. Capital tends to flow to those places where it will receive the highest return, after due allowance has been made for risk and marketability. The productivity of capital depends upon its quantity relative to the quantities of the other factors of production, viz., labor and natural resources. The productivity of capital will be high where capital is scarce and labor and natural resources relatively abundant; it will be low where capital is abundant and labor and natural resources scarce. The interest rate tends to equal the value of the marginal product of capital. In old and economically mature countries savings have accumulated to such an extent that both the value of the marginal product of capital and interest rates are low, whereas in young, undeveloped, and backward countries, capital accumulations are usually small, and both the value of the marginal product of capital and interest rates are high. Interest-rate differentials thus naturally attract the excess capital of mature regions to the undeveloped and backward regions. It was the almost unlimited opportunities for the profitable utilization of funds and the superior yield on investments in the New World that attracted funds to the United States from Europe during the century before 1914. It was also the

high yield on foreign investments that drew capital from the United States to Latin America and Europe after 1920.<sup>4</sup>

The yield on capital and the safety of the principal are not the only considerations that govern the export of capital. The export of funds has often been determined by political considerations rather than by economic or financial calculation. How political circumstance guided the direction of capital-flow in the half century prior to 1914 has been aptly portrayed by a leading student of the problem.

In the lending countries international financial transactions were supervised in accord with calculations of national advantage, which were often unrelated to the direct financial inducement offered the owners of capital. Peoples and governments exerted themselves to direct the capital to those purposes which were judged likely to strengthen the national state, especially in time of war, or increase the chances of extended dominion. Capital was called upon to abstain from investment in the lands of potential enemies. It was urged or commanded into the services of allies. It was encouraged to develop the areas within the political system of the country where it accumulated. It was upheld in ventures which sustained a national political ambition or hope. In France and Germany, and within the alliances which they headed, it came to be commonly regarded as a servant of national purposes rather than an ordinary private possession to be disposed of in accordance with the private judgment and on the private risk of the owner. Within Great Britain this attitude was much less common, yet not without influence upon the course of British investment.<sup>5</sup>

Foreign loans that are made for political reasons have not always been for exploitation, aggression, or the advancement of imperialistic ambitions. In recent years the United States government has made large foreign loans to promote the good neighbor policy, to develop the resources of allied and neutral countries, and to hasten the defeat of the Axis powers in other ways.

A factor of no little importance in the direction of capital investment has been the influence of investment bankers. The ordinary investor is not competent to make a proper appraisal of the worth of

<sup>4</sup> Exports of capital to certain countries may be discouraged by poor records for financial integrity, high taxes, fear of expropriation of foreign properties, and various government restrictions.

<sup>5</sup> Herbert Feis, *Europe the World's Banker, 1870-1914*, Yale University Press, 1930, pp. 465-466.

## 660 International Trade and Commercial Policy

particular securities; he must usually rely upon the advice and judgment of his banker. Where bankers have been able to realize much larger profits from the sale of foreign securities than from the sale of domestic issues, they have been led to prefer and encourage foreign investment. Dr. White points out<sup>6</sup> that in recommending French rentes or City of Paris bonds in the decades before World War I French banks stood to realize little or no profit, but in recommending Bulgarian or Brazilian loans there was opportunity for big gains. The poorer the security of the borrower and the more pressing his need, the less particular is he apt to be, the less shopping around he can afford to do, and the more he is willing to pay to the underwriters. Constant pressure was exerted on the French investor to buy those foreign securities that the banks were issuing, although the yield which these securities afforded the investor did not, in White's opinion, amply compensate for the risks undertaken. French investors bought foreign securities in those years only because the French bankers used every artifice at their command to persuade the investors that foreign securities were to be preferred to domestic issues. The bankers preferred to underwrite foreign securities because their profits from such underwritings were much greater than from sales of domestic securities. Prospects of underwriting commissions much higher than those available on domestic issues and the necessity for a continuous flow of new securities to keep large staffs of bond salesmen employed go far to explain the large underwritings of foreign issues by American investment bankers during the 1920's.<sup>7</sup>

Mention has already been made of the vast international capital movements that took place during the inter-war period because of disturbed economic and political conditions and the fear of currency disturbances, inflation, government restrictions, and war. Capital that moved for such reasons did not migrate for permanent investment; it only sought security. It was ready to leave its new haven as suddenly as it had left its native land, provided only that some other country promised greater security than its newly adopted custodian. These movements of "hot money" caused serious disturb-

<sup>6</sup> *Op. cit.*, Ch. XII.

<sup>7</sup> *The United States in the World Economy*, p. 96.

ances in foreign exchange markets, banking reserves, and general economic conditions.

### TYPES OF FOREIGN LOANS AND INVESTMENTS

Foreign loans and investments are classified according to various bases: the types of borrowers and lenders, the currency in which the obligations are stated, the purpose of the loan, the duration of the loan, and the form of the investment.

(1) Loans may be made either by private individuals and groups, or by governments. Private loans, i.e., those made by private individuals or groups, may be extended to private enterprises abroad or to foreign governments; or private capital may be invested directly in subsidiary enterprises abroad. Until the outbreak of war in 1939, the great bulk of foreign lending and investing was by private individuals and corporations; most of these private loans were advanced to private borrowers. Foreign government bonds have not infrequently, however, found favor among investors. Before 1914 European investors purchased the bonds of certain Caribbean states, and French peasants became large investors in Russian government securities. In the 1920's the bonds of various foreign governments found their way into the strongboxes of American investors. Governments have at times also been important lenders. Government loans, are usually extended to other governments, although governments have infrequently invested in private enterprise abroad. During the first World War, the United States government loaned the Allied governments sums in excess of ten billion dollars, while in the second World War American lend-lease advances to other members of the United Nations amounted to nearly five times this amount. Examples of government investments in foreign private enterprises are the investments of the British government in the Suez Canal and in the Anglo-Persian Oil Company.

(2) The foreign obligations purchased by investors in the lending country may be expressed in the currency unit of the lending country, in that of the borrowing country, or in that of a third country. Some foreign bonds have provided for the payment of principal and interest in any one of two or more currencies, depending upon the choice of the investor. Securities that are issued in terms of the bor-



## 662 International Trade and Commercial Policy

rower's currency are called *internal*; those issued in terms of the lender's currency, or some third currency, are called *external*. Although many of its obligations are owned abroad, the United States has no external debt. Most of the foreign securities sold in the United States are payable in American dollars, i.e., they are external obligations of the debtors.

In periods of currency disorders and widely fluctuating foreign exchanges, lenders may suffer serious loss through the depreciation of foreign currencies if the foreign bonds that they own are stated in terms of a foreign currency, i.e., are internal. For this reason, investors in foreign bonds usually insist that such issues be made in terms of their own currency or that of some third country whose currency is considered safe. Lenders may, however, profit from an investment in a foreign internal debt. After the devaluation of the dollar in 1934, American holders of foreign bonds that were payable in stable gold currencies, e.g., French francs, Swiss francs, or Dutch guilders, were able to realize much more than the face dollar value of their coupons by accepting payment in one of the foreign gold currencies. Where the debts are external, the borrower assumes the risk of exchange because he must acquire foreign exchange in order to service the debt and repay the principal. Exchange depreciation causes an increase in the debt burden of the borrower in the case of an external debt, and may be responsible for the borrower's inability to meet his debt payments.

(3) A third classification of foreign loans and investments is based on the purpose of the loan, that is, whether the loan is to be used for a productive or an unproductive purpose. The term "productive," it should be noted, is not here used in the sense in which it is ordinarily used in economics, viz., to refer to activity which results in an increase in the sum total of satisfactions. The emphasis here is rather on activity that increases a nation's productive powers and thus facilitates the servicing and repayment of the loan. In this sense, loans to maintain court display, build palaces, improve housing conditions, beautify cities, or prosecute foreign wars would be considered unproductive. Although most of these activities do produce psychic income and hence may be suitable fields for public investment, they are not necessarily suitable for foreign borrowing. Capital so invested produces little *money* income, so that the pay-

ment of both interest and principal depends solely upon the taxing power of the borrowing government.<sup>8</sup>

Loans to build roads and railroads, develop mines and plantations, construct factories, or build public utilities, on the other hand, increase the productive power of a nation, and may be considered productive. If repayment difficulties are to be avoided, however, the mere increase of a nation's physical output is not enough; a foreign borrowing program, if it is to be successful, must also be associated with a potential future increase in a country's exports relative to its imports. To achieve this objective, the foreign borrowings should be invested, at least in part, in projects designed to increase the productivity of export industries or of industries that produce goods that replace imports. There can be little doubt, for example, that German productive power was materially increased as a result of foreign loans during the nineteen-twenties. Unfortunately, the additional industrial production of Germany did comparatively little to enable her to meet the interest payments on her foreign borrowings. If foreign investment programs of the future are to be more successful than those of the inter-war period, both lenders and borrowers must give greater consideration to the future development of favorable trade balances by debtor nations than they have in the past. Lenders must also reconsider their own import policies in the light of their creditor position.

(4) Foreign loans and investments are also classified according to the period of the credit. When one speaks of investment, the reference is usually to a *long-period*, i.e., for periods of anywhere from five years up. Publicly issued bonds fall into this category; so do foreign equities and direct investments in foreign plants.

At the same time, it must be remembered that the foreign trade of any country is almost entirely financed by credit. Although this credit may take many forms, the most important is the bill of exchange. This is a short-term credit, extended usually for a period of less than twelve months. The bill of exchange is unsuitable, however, for financing trade in capital goods for which somewhat longer credits are required, but for which long-term credits are not adapted. The tremendous increase in the mechanization of industry throughout the world has created a demand for trade credits of much longer

<sup>8</sup> This is not to imply that all government borrowing is unproductive.

## 664 International Trade and Commercial Policy

duration than the bill of exchange for financing the production and sale of machinery and other capital goods. The foreign purchaser often requires two, three, or even five years before he can complete his payments, and he is therefore inclined to give his contracts to those sellers who can provide sufficiently long credits. A real need for *medium-term* credits (one to five years) has thus arisen. Because the resources of exporters are rarely adequate to extend medium-term credits, outside assistance has been required. In the United States, medium-term credits for the purchase of American heavy machinery have been extended by the Export-Import Bank. In Great Britain, the Export Credits Guarantee Department of the Board of Trade has undertaken to guarantee private credits for periods of time up to ten years, to finance foreign purchases of British machinery and other producers' goods.<sup>9</sup>

Medium-term credits possess several advantages over long-term credits. First, initial foreign exchange disturbances are minimized because the export of capital is correlated with an equivalent export of goods. Second, the sales of domestic industries are improved by the full amount of the capital export, a result that does not necessarily follow from long-term lending through the new-issues market. Third, the risks attached to medium-term lending are relatively smaller because the term of the credit is shorter and because the conditions under which the loans are made give the lender a greater control over the borrower. Exports of capital goods are ordinarily spread over a considerable part of the period of the credit, so that the lender may expect to begin to receive service payments before all the exports of goods have taken place. If these payments are not promptly forthcoming, pressure may be placed on the borrower by withholding further shipments of goods, thus threatening him with being left with a half-finished structure. Since, also, the exporter is normally in intimate contact with the construction abroad, he can keep well informed of the financial position of the borrower and can refuse further credits if there are adverse developments.

(5) Finally, foreign investments may be classified as "portfolio"

<sup>9</sup> Various other governments have established departments to guarantee private export credits. Facilities of this nature have also been provided in Germany, France, Italy, Belgium, Czechoslovakia, Denmark, Japan, Austria, Norway, Sweden, Finland, Poland, and Spain.

or "direct." "Portfolio" investments are the foreign security holdings of private individuals, insurance companies, investment trusts, and the like; the individual holdings are so small that they give the security holders no control in the foreign enterprises. "Direct" investments include all foreign enterprises controlled by a country's nationals, corporate or individual, or in the management of which a country's nationals have an important voice. "Direct" investments, in other words, represent foreign enterprises which are not only financed by a given country, but which are also controlled or managed from within that country.

*American Direct Investments Abroad.* Direct investments abroad may be divided into three groups, depending upon the form of ownership. First, there are the direct subsidiaries and other affiliates of American corporations whose chief field of operation is in the United States. Well-known examples are the far-flung holdings of the Ford Motor Company, General Motors Corporation, the Standard Oil Company of New Jersey, and International Business Machines Corporation. Second in importance are American corporations organized for the specific purpose of operating abroad. Outstanding among such corporations are the American and Foreign Power Company, International Telephone and Telegraph Corporation, and Cerro de Pasco Copper Corporation. The third group is composed of foreign corporations in which the controlling interest is held by Americans, such as International Nickel Company of Canada, Ltd., Dome Mines, Ltd., and Compañía Swift Internacional, S.A.C. Frequently, the controlling shareholders in the last group have also been the founders of the corporation.

Foreign enterprises may also be classified according to the purpose of the investment. The first group comprises branch plants; these include foreign sales subsidiaries as well as manufacturing plants. Such enterprises are established either as a substitute for, or to facilitate, the exportation of goods manufactured in the home country. The second group includes enterprises organized to develop foreign natural resources and raw materials. The object is frequently to provide an assured source of materials for the parent company in the United States. The bauxite mines of the Aluminum Company of America and the rubber plantations of tire producers are conspicuous examples of enterprises based upon this incentive.

## 666 International Trade and Commercial Policy

The third group embraces such enterprises as railroads, public-utility systems, banks, insurance companies, theaters, and the like, industries that are not dependent on the location of a particular mineral deposit, soil, or climate. The prime motivation here is the prospect of realizing a greater profit from foreign enterprise than from domestic enterprise. The quest for greater profit is also a motive in the first two groups, although not usually the chief one.

American direct investments abroad were, before the depression, about equal to private holdings of foreign securities. They continued to increase after 1929, when the more formal type of foreign lending was at a standstill. Several factors encouraged direct foreign investments at a time when private investors had become distrustful of foreign securities. First, there was a certain amount of "involuntary" investment. International concerns with blocked foreign balances frequently found themselves in a position in which they could only repatriate their funds at a great discount, leave them abroad and run the risk of depreciation, or invest them in the country imposing the exchange restrictions. Many preferred to invest them abroad.

Second, the growth of economic and political nationalism was occasionally responsible for the growth of direct investments. In France, for example, foreign oil companies were obliged to erect local refineries, while in Japan they were compelled to maintain in storage at least a six months' supply of gasoline. Branch factories have sometimes been employed to counter foreign "buy at home" movements. One of the most important causes of the establishment of foreign branch plants has been high protective tariffs. In some cases, the establishment of a better sales and distributing organization and a satisfactory maintenance service has been sufficient to increase exports despite tariff barriers. In others, it has been necessary to erect assembly plants or factories which carry out the entire process of manufacture with domestic labor and raw materials and foreign capital, in order to prevent a decline in exports. An increasing number of United States firms have established factories in Canada since the Ottawa Conference of 1932 in order to manufacture products which are admitted into other Empire countries under the British preferential tariff.

American capital has also moved abroad in a few instances to take

advantage of low foreign wages or to reduce freight charges by locating factories close to markets and materials. Foreign patent legislation, too, has encouraged direct investment abroad. Canadian laws, for example, do not protect patents within Canadian territory unless, after three years, the patented article is manufactured within the country in quantities sufficient to meet the reasonable requirements of the public.

The risks of foreign investments tend to be more critically appraised when the investments are direct because such investments are undertaken only by persons who have a specialized knowledge of the particular industry concerned. Because this type of investment provides an avenue for exporting technical and managerial services, it may even reduce the risk. Such investment, furthermore, diminishes the exchange difficulties that are sometimes encountered in making the loan, for the export of capital is frequently correlated with an export of goods. In addition, this form of investment lessens the exchange difficulties involved in making service payments. Most direct investments are of an equity character, and, unlike external bonds, do not carry contractual service obligations payable in foreign currencies. In periods of business depression foreign-owned enterprises will have little or no profit to remit; consequently, already overburdened exchanges will not be further strained by attempts to make interest payments to foreigners. Since the owner, rather than the borrower, must stand the loss in the event of currency depreciation, moreover, there will be less inclination to transfer service payments even if operations are profitable.

#### THE STATE AND FOREIGN INVESTMENT

From time to time, governments in most countries have considered it necessary to regulate, in one way or another, the external lending or borrowing of their nationals. State action has been undertaken both to encourage and to discourage foreign investment. It has sought to force foreign lending into certain channels for various reasons, both economic and non-economic.

Capital export in the mercantilist period was retarded by restrictions on the export of specie and on the emigration of industrial enterprises and skilled craftsmen. During the period of economic liberalism in the middle of the nineteenth century there was com-

## 668 International Trade and Commercial Policy

plete freedom of capital export; even conservative British governments refused repeated demands for intervention to impede the export of capital and to protect British investments abroad. The return of protectionism in the last quarter of the nineteenth century was accompanied by a revival of government control of foreign investment. The export of capital was encouraged in order to stimulate commodity export and in order to establish secure economic and political positions in regions in which international rivalry was keen. At the same time, the resurgence of the movement for economic self-sufficiency caused certain governments to intervene for the prevention of capital export. Such intervention sought to preserve the productive forces of the nation for the fatherland and to guard against the lending of aid to the industrial development of present and potential competitors. Intervention was in the main, however, discriminating; it was directed against *certain* borrowers rather than against capital export as such. Its purpose varied from the promotion of political alliances and colonial expansion schemes to the protection of investors from speculative excesses.

Government restrictions upon exports of long-term capital in the inter-war period were usually initiated for one, or both, of two main reasons. First, it was feared that uncontrolled exports of capital would cause the external value of the lender's currency to depreciate. Second, it was feared that if such exports of capital were permitted, rates of interest within the lending country would be forced to undesirably high levels. If domestic interest rates were kept low, furthermore, there was danger that capital exports which were undesirable for the first reason would take place.

Government control of capital export may be exercised in various ways. In Great Britain, such control has been exercised not by statutory authority, but by "requests" to the capital market by the Treasury and the Bank of England. Because the largest issuing houses in London combine acceptance business with their underwriting activities, and are thus ultimately dependent on the willingness of the Bank to rediscount bills accepted by them, they can be placed in the unenviable position of being denied such facilities if they incur the serious displeasure of the Bank. Furthermore, it is clearly in the interests of the issuing houses to keep on good terms with the author-

ities if they hope to receive favorable consideration in the distribution of any business which the Treasury or the Bank may have the power to allot. In France, the opinion of the Quai d'Orsay has to be obtained before the flotation of a new foreign issue can be attempted; by excluding foreign issues from the Paris exchange the minister of finance can practically eliminate the unwanted foreign investments. Actually there is a high degree of cooperation in this matter, not only between the Quai d'Orsay, the Treasury, and the Bank of France, but also between these institutions and the press. The most severe of all controls over capital export was that maintained by Nazi Germany. Complete exchange control was established,<sup>10</sup> and the domestic and foreign capital markets were strictly regulated. The sale of new foreign issues in Germany and the export of currency were prohibited, while the purchase of foreign securities was made illegal. Only the purchase of German bonds on foreign stock exchanges was permitted. Since Germany's default had caused German issues to depreciate heavily abroad, they could be bought cheaply, and their purchase provided a stimulus to "additional" German exports.

Capital exports have been controlled in the United States for different reasons and by different methods. In 1922 the State Department requested that investment houses, before floating a foreign bond issue, submit to it the details of the issue for examination of its possible bearing upon government foreign policy. Although the bankers were not legally bound to refrain from proceeding with an issue of which the Department disapproved, they made it a policy to comply with the Department's wishes; for they realized that it would be difficult to dispose of an issue that had the disapproval of the Department and that foreign investors occasionally need the support of their government in disputes abroad. Under this ruling, the government did not undertake to pass on the soundness of the contemplated loan. It looked rather for features that might cause ill will abroad, have unfortunate political repercussions, or were inconsistent with the economic policies of the United States. The financing of revolutions in friendly states and loans to small, backward countries on which the commissions to American bankers were

<sup>10</sup> See Ch. XIX.



## 670 International Trade and Commercial Policy

exorbitant were frowned upon. No approval of loans was given. If a loan was deemed unobjectionable, the Department merely announced that it had no objections.

*The Johnson Act.* The Johnson Act of 1934 made it a criminal offense for any individual or institution in the United States to purchase or sell the securities of, or to lend money to, any government, or political subdivision thereof, that is in default in any of its obligations to the United States government. Private corporations in defaulting countries or political subdivisions of such countries which are not in default of their obligations were not affected by the law. Also, the provisions of the Act did not apply to the United States government. The Act was designed to compel war-debt payments to the United States, but in this respect it proved disappointing.

The importance of the Act for the postwar period has been reduced practically to zero as a result of the Bretton Woods Agreement. Section 9 of this Agreement specifically exempts from the provisions of the Johnson Act any country which is a member of both the International Monetary Fund and of the International Bank for Reconstruction and Development.

*Neutrality Acts of 1936 and 1937.* The neutrality legislation of 1936 and 1937 imposed further restrictions on foreign lending. Lending to nations at war was thought to increase the danger of the military involvement of the lender and to make difficult an effective neutrality policy. When a state of war had been proclaimed, therefore, it became unlawful to purchase, sell, or exchange bonds or other obligations of a government at war, issued after the date of proclamation, or to lend or extend credit to any such government or any person active on its behalf. The President might make exceptions, however, for ordinary commercial credits. The legislation also forbade the entry of vessels of United States registry into ports of belligerent nations.

The President had considerable latitude in determining whether or not a state of war existed. When Japan invaded China in 1937, the President did not declare that a state of war existed. In November, 1941, Congress amended the Acts to permit American vessels to sail into the ports of belligerents and to permit the arming of such vessels. These amendments emasculated the Acts; while Congress preferred not to repeal them, the effect was similar. By the lend-

lease program authorized by Congress in March, 1941, the provisions designed to prevent American dollars from financing belligerents was nullified.

*Export-Import Bank.* The United States government itself entered the field of foreign finance in 1934 by the establishment of the Export-Import Bank.<sup>11</sup> The Bank was organized with a capital of 175 million dollars subscribed to by the Reconstruction Finance Corporation and the Treasury Department. Funds needed by the Bank are provided by the Reconstruction Finance Corporation. The Export-Import Bank was authorized originally to have outstanding at any one time commitments of an amount not to exceed 700 million dollars, but its lending authority was increased in June, 1945, to three and a half billion dollars and its capital to one billion dollars.

The Export-Import Bank was organized to help finance exports of United States goods at a time when our foreign trade had declined to a low level. The original purpose of the Bank has since been expanded to include assistance to foreign countries and the implementation of United States foreign policy. Loans have been made to more than 30 countries in Latin America, Europe, Asia, and Africa, as well as to exporters and manufacturers in this country. This money has been advanced not only to promote trade, but also to stabilize the dollar values of foreign currencies, to reconstruct foreign economies, and to build industries and develop resources in foreign countries. After the Japanese attack on Pearl Harbor in 1941, the Bank endeavored to strengthen Chinese resistance to the Japanese by granting substantial loans to China. With the entry of the United States into the war, the Bank financed imports of strategic materials and made extensive loans to Latin American countries to expand the production of those materials and to help promote friendly relations between those nations and the United States. The Bank has financed a steel mill in Brazil, refrigeration plants in Cuba, power plants in Uruguay and Brazil, a railroad in Portugal, the Burma Road, the Inter-American Highway and feeder roads in Central and South America, fiber-growing projects, and metal mining.

<sup>11</sup> Originally two Export-Import Banks were created, one to finance trade with Russia, the other to finance trade with countries other than Russia. The two banks were merged in 1936 after debt negotiations with Russia had broken down, so that there was no trade with Russia to be financed.

## 672 International Trade and Commercial Policy

As originally set up, the Bank was prepared to handle short-term (up to 12 months) and medium-term (one to five years) credits and to guarantee private loans. Its policy has been to support, rather than compete with, private banks in making foreign loans; it has confined its lending to projects where private finance is not available on reasonable terms. Its loan contracts normally contain a tying clause which provides that machinery and materials not available in the borrowing country shall be purchased in the United States and transported in United States ships. In recent years its resources have been used largely to guarantee loans made to American exporters by private banks and credits advanced by United States manufacturers and shippers to foreign buyers rather than to make direct loans itself. In the years ahead it is planned that the Bank shall continue these operations, except that they shall be on a larger scale and that advances shall be for longer terms, say up to 20 or 30 years.<sup>12</sup>

*Lend-Lease.* By the Lend-Lease Act of March, 1941, the United States government entered into the greatest lending venture in history. The immediate occasion for this legislation was the pressing need of Great Britain for dollar resources in her struggle against the Axis, after she had exhausted her own means of purchasing required materials and equipment in this country. After 1941 lend-lease advances were made to the other United Nations. The Act permitted the President "to sell, transfer, exchange, lease, lend, or otherwise dispose of" to the government of any country whose defense the President deemed vital to the defense of the United States any defense article. Between March 11, 1941, and October 1, 1945, lend-lease aid totaling more than 46 billion dollars was supplied by the United States, of which 69 per cent was furnished to the British Empire and 25 per cent to Russia. Lend-lease advances have been regarded as contributions of material to a common pool with which a

<sup>12</sup> Up to the end of 1944 the Bank had made commitments of \$1,200,000,000. Loans of \$477,836,912 had been made, of which \$252,018,901 had been repaid and \$225,818,010 were outstanding; total outstanding commitments were \$364,232,704. Profits of \$37,329,324 had been made from these transactions. By the spring of 1946, practically its entire expanded lending power of \$3,500,000,000 had been exhausted, and an increase of \$1,000,000,000 to \$1,500,000,000 in its lending power was being urged.

common war was being waged. Although neither the Johnson Act nor the loan provisions of the Neutrality Acts had been repealed at the time of the passage of the Lend-Lease Act, the practical effect of the latter was to repeal the former two acts.

The form which lend-lease settlement will take has not been wholly settled; settlement will be arranged with each individual borrower. Unused materials are to be returned. All the lend-lease agreements authorized the postponement of settlement until after the war and repayment in a form that would not burden commerce. Aid received by the United States from other countries is to be offset against our advances. This "reverse" lend-lease totaled \$6,256,871,000 through July 1, 1945. The British lend-lease account was settled by a payment of \$650,000,000, made possible by a loan of that amount to the British government by the United States government. This was part of a loan of \$4,400,000,000 advanced to the British government.

The insistence of the United States government upon considering the lend-lease advances as advances of materials rather than as money loans, as we did during World War I, was an act of farsighted statesmanship. Apparently the only obligation that the debtor nations owe us is repayment in goods or services; if we refuse to accept these, we shall have no further claims upon these foreign governments. If we again choose to retire behind a high tariff wall and refuse to accept larger amounts of foreign goods and services, we must realize that we do so at the direct cost of foregoing repayment of our lend-lease advances. Attempts to repay the advances of World War II are not to be permitted to disorganize foreign exchange markets, balances of payments, and internal currency systems, as did attempts to repay the war debts of 1914-1919. In any case, the stipulation that repayment of these advances shall be in such a form as not to burden world commerce probably means that relatively little ever will be repaid.

*Government Encouragement to International Lending.* The ways in which the government may encourage or advance foreign investment may be divided into five classes:<sup>18</sup>

<sup>18</sup> Cf. Royal Institute of International Affairs, *The Problem of International Investment*, pp. 86-87.

## 674 International Trade and Commercial Policy

- (1) The provision of facilities whereby the purchasers of a country's exports may obtain short- or medium-term credits from exporters at reasonable rates.
- (2) Direct investments by the state. Such investments are often made for purposes of national defense; many of them are unproductive in the sense that it would not pay private enterprise to undertake them.
- (3) The encouragement of investment in colonial possessions either by direct government guarantee of the securities of colonial governments or of private firms in the colonies, or by giving preference to issues of colonial securities.
- (4) The encouragement of investment in certain non-colonial areas for political purposes. This type of investment is frequently accompanied or followed by the use of force to protect the investor.
- (5) Loans for stabilization and relief purposes which are sometimes guaranteed, and sometimes merely encouraged by the governments of the lending countries.

Control over international capital movements has also been directly exercised by the governments of borrowing countries. Both Austria and Germany set up in the 1920's loan councils whose duties were to limit the borrowings of public authorities and to impose upon them policies designed to reduce expenditures and control deficits. The success of such councils has not been impressive. In Germany a vast amount of reckless municipal borrowing was permitted. Public interference with an inflow of capital which brings in its wake tangible, if ephemeral, prosperity is extremely unpopular. The most that can probably be expected of loan councils is a not too strict censorship over the projects for which foreign capital is desired and a centralization of public borrowings that will make it possible to spread out such borrowings over time and enable public authorities to secure more favorable terms.

*Diplomacy and Lending.* Foreign investments have been the frequent occasion for interference by the governments of great powers in the internal affairs of weaker powers. A flow of capital from one stable and powerful state to another rarely gives rise to political controversy; such loans are likely to be on terms which assure a fair degree of security and a reasonable certainty of repayment. Even

when depression causes wholesale bankruptcy and government action is demanded and granted, no important changes are apt to occur in the political relations between the creditor and debtor nations. When capital flows from a great power to a weak and backward state, however, there may be little assurance of stability, productive use of funds, or repayment, and sometimes no assurance even of honest intentions on either side. Defaults on such loans are frequent, and these cause investors to appeal to their government for protection. Such appeals are usually heeded, both because bankers and investors are politically influential and because the resulting diplomatic controversies offer opportunities for imperialistic expansion.

The governments of capital-exporting states may bring varying degrees of pressure to bear on governments of backward states in the interests of investors and concessionaires. They may, to begin with, refuse to extend diplomatic recognition to governments that confiscate property, repudiate debts, or by other means reduce the profits of foreign nationals. Because the governments of backward states are in a condition of chronic financial embarrassment and are ordinarily unable to secure foreign loans without diplomatic recognition, the withholding of such recognition is a powerful weapon in the hands of a foreign government. If the withholding of diplomatic recognition proves ineffective, the government of the lenders may resort to military or naval demonstration or armed intervention in order to collect the debts owed its nationals. The creditor state may even impose its control on the debtor state. This may involve only the appointment of customs collectors or financial advisors by the intervening power, coupled with whatever action is necessary, such as the landing of marines, to compel the local government to accept these services. Or it may involve the extinction of the sovereignty and independence of the borrowing state and its annexation by the creditor state.

The diplomatic and military pressures which great powers have from time to time employed against debtor states have not always been invoked primarily from any consideration for the pecuniary interests of investors and concessionaires. The power of bankers and investors to export or to refuse to export capital has been regularly employed by great powers as an instrument of national policy to

## 676 International Trade and Commercial Policy

achieve diplomatic and political purposes. Foreign loans have been encouraged, or discouraged, to strengthen an ally, to weaken a past or prospective enemy state, as part of a diplomatic bargain to obtain political concessions from another state, or as a means of securing economic and political control of backward regions. The interests of particular investors and entrepreneurs have been utilized by governments to serve these larger purposes quite as often as they have themselves been the objects of government solicitude. While bankers and investors have found it lucrative to call upon governments to protect their interests abroad, patriotic statesmen, in pursuit of political influence, diplomatic prestige, and imperial possessions, have at the same time found bankers and investors effective, and willing, tools of power politics.

### ECONOMIC EFFECTS OF CAPITAL EXPORT

*Balance of Trade.* Since a net export of capital can be made only in the form of goods or services,<sup>14</sup> the export of capital necessarily affects the balance of trade of both the lending and borrowing countries. During the period in which the loan is being transmitted, the lender will experience a favorable trade balance (including all service items) and the borrower an unfavorable balance. The mechanism by which these necessary changes in the balance of trade are effected has been analyzed at length in Chapters VIII and IX. Briefly, an international transfer of purchasing power takes place which in turn affects money incomes and commodity and factor prices in both countries; the altered incomes and prices induce changes in the international flow of goods.

When the borrower begins to make payments on interest account and eventually repays the principal, the trade balances of the two countries are reversed: that of the lender becomes unfavorable, that of the borrower favorable. The lender may for a while, however, maintain her favorable trade balance, even while she is receiving interest payments, if she continues to lend abroad sums in excess of her interest receipts. But a creditor nation cannot maintain a favor-

<sup>14</sup> A net export of capital can also be made in the form of gold. This is of significance, however, only in the case of a panicky flight of capital or when the banks in the borrowing country are seeking to strengthen their gold reserves.

able balance of trade indefinitely. As the volume of foreign loans outstanding increases, interest receipts from foreign debtors increase proportionately, until the annual receipts on interest account eventually exceed the annual volume of new loans—unless lenders are willing to make fresh loans at an ascending rate. Only through an unfavorable balance of trade, moreover, can a creditor nation accept full repayment of her foreign loans.

*The Basic Case for Foreign Lending.* Because the opportunities for profitable investment tend to be greatest, and the rate of return on capital highest, in those industries that directly or indirectly fulfill the strongest consumers' demands, savings are drawn into those industries where consumers most want output increased.<sup>15</sup> Consumer choices thus largely direct the allocation of savings among investments, and the rate of return available in different investment opportunities is the basic allocation guide. Both the lender and society as a whole benefit from having savings converted into those investments that promise the greatest return, after due allowance has been made for risk. The existence of national boundaries does not invalidate this basic principle of gain from exchange and lending. International loans are more productive than domestic loans when the anticipated rate of return on the former (after due allowance for risk) is greater than on the latter.<sup>16</sup> The transfer of capital from a country where its marginal productivity is low to a country where it is high means a more efficient combination of the productive agents and an increase in the combined national income of the two countries.

*Benefits to the Borrowing Nation.* Capital imports may bring considerable benefits to the borrowing nation. These include a heightening of its commodity imports, an expansion of its productive powers, and an increase of its wealth. Capital imports also cause a temporary increase in its barter terms of trade.<sup>17</sup>

<sup>15</sup> Actually, the available loanable funds will be allocated among the alternative investment fields in such a way that at the margin the value of the marginal product of capital will be the same in all uses, excluding allowance for risk.

<sup>16</sup> Foreign loans for such purposes as war and court display are, of course, not productive. The argument of the text refers to productive loans.

<sup>17</sup> The effects of international capital-flows upon the terms of trade and national advantage are discussed more fully below.



## 678 International Trade and Commercial Policy

A large part of real capital consists, to be sure, of goods that can only be produced with domestic economic resources. Buildings, roads, and railroads, for example, must be fabricated on the spot. Nevertheless, many articles essential to internal development—such as machinery, railroad and electrical equipment, and even some raw materials—may have to come from abroad. These may be acquired through net borrowing from abroad, for foreign borrowing permits a country to import goods of greater value than those it exports. By borrowing abroad, furthermore, a country is able to consume beyond its current production of consumers' goods and so devote more of its productive resources to investment projects, the majority of which have to be undertaken with its own resources on the spot. Foreign borrowing, in other words, places at the disposal of a nation for investment a larger volume of funds than its citizens are willing to provide out of their income.

The increase in the size of the national income which foreign borrowing tends to foster will probably go hand in hand with greater equality in its distribution. The import of capital causes interest rates to fall in the borrowing nation and the returns to land and labor to rise, because the more limited the supply of any one of the agents of production in proportion to the others, the higher the price it can command for its services. The inflow of capital makes capital more abundant and land and labor scarcer than before.

The inflow of capital may increase the productive powers of the borrower not only directly, but also indirectly by stimulating the immigration of labor. This is most likely to occur where the movement of capital is toward a country in which natural resources are abundant but labor scarce. Where the flow of capital is toward a nation plentifully supplied with both natural resources and labor, immigration is unlikely to accompany capital import; but capital import may make unnecessary an *emigration* of labor to regions of higher labor productivity.

The inflow of labor that accompanies the capital import may be not only of ordinary skilled or unskilled laborers, but of technical experts as well. International capital movements thus tend to diffuse the knowledge of all sorts of technical improvements much more rapidly than would otherwise be possible. A particularly strong tendency to draw business leaders and technical experts from the

lending country may be expected when the export of capital takes the form of the establishment of branch factories in new countries. In such cases, the capital is more likely to be invested in industries that compete with, rather than in those that are complementary to, industries in the lending country; for it is probably in their export industries that the technicians of creditor countries have acquired their superior skill.

Such benefits are offset, in part, by the danger that the lending nation may gain financial and political control of the debtor. Many a backward nation has discovered to its sorrow that capital imports have resulted in a loss of its sovereignty. Furthermore, the gains in national production may be of little benefit to the nationals of the borrowing nation if the expropriation of land and the exploitation of native labor divert most of these gains to the lenders.

*Benefits to the Lending Nation.* Capital exports may lessen the risk of investment by securing a wider geographical distribution. If foreign investments are concentrated in one or two countries, or in countries of doubtful financial stability, however, the risk of loss may be enhanced rather than diminished. Foreign securities sold abroad or employed as collateral to establish credits abroad against which the banks can sell exchange may, too, be used to meet temporary adverse movements of the foreign exchanges. They thereby obviate the necessity of exporting gold and help to protect the banking system from drains on the national gold reserve caused by temporary movements in exchange rates. The constant movements of gold between countries demonstrate, however, that the use of securities is not always the most expedient method of establishing credits abroad. Moreover, securities so used must be relatively stable in price and be of the highest standing; high-quality domestic bonds may meet these qualifications better than foreign securities.

It should be pointed out that only those capital investments are worthy of undertaking which promise to yield, if completed and put into operation, a net return above all costs. A project must give promise of earning a gross income sufficient to cover the direct costs of its operation, to maintain the fixed capital by appropriate depreciation charges, and to yield a rate on the investment at least as large as the rate at which the funds were borrowed. This is the minimum income of a successful investment, whether foreign or domes-

## 680 International Trade and Commercial Policy

tic. But foreign investment must guarantee something more: it must lead to an increase in the net exports of the borrowing nation sufficient to service the loans. Unless foreign borrowings contribute substantially to the foreign balance, defaults on foreign obligations are inevitable.

A benefit from capital exports of far greater importance than the diversification of the investments and the protection of the gold reserve of the lending nation is the increase in the lending nation's national income. There are three possible sources of the increase in national income that results from capital exports: (1) a higher rate of return on foreign investments than on domestic investments; (2) a cheapening of imports as a result of improvements in foreign industry, agriculture, and transportation brought about by the borrowed capital; and (3) a reduction in the costs of production of domestic goods because of an increase in the foreign demand for these goods, with a consequent development of more and larger plants that lead to lower costs from internal and external economies. It has already been pointed out that capital is usually reluctant to migrate to foreign countries except when it is assured of yields higher than those obtainable at home. Were the capital exported to be invested domestically, yields on domestic investments would be forced still lower. The failure to invest the exported capital at home, however, deprives the other factors of production—labor, land, and enterprise—of increased rewards, and thus prevents the attainment of a greater equality in the distribution of the national income.<sup>18</sup>

The failure of the other factors of production to gain the higher returns that might have been expected had the exported capital been invested at home, however, does not mean that these factors do not derive benefit from capital exports. They tend to gain by the future cheapening, as a result of the new investment, of the costs of imported goods. The lending nation may gain by obtaining goods formerly imported from the borrowing nation more cheaply than she did before, by securing more cheaply than before goods previ-

<sup>18</sup> White suggests that the large capital exports by France in the 30 years before 1913, the result of a strong French bias for foreign investments, was responsible for a lack of confidence in domestic enterprise and the sluggish development of French industry and enterprise during a period when American and German industry was progressing phenomenally.

ously imported from other nations, or even by acquiring more cheaply goods that were previously produced at home. She may gain even though the article now imported displaces a commodity which the lending nation previously exported. But the lowering of the foreign costs of producing goods exported by the lender may injure the lending nation if she consumes relatively little of such goods. Whether, in this case, she gains or loses will depend upon the extent of her gains as an importer as compared with the extent of her losses as an exporter, by being compelled either to accept lower prices for her exports or to shift to what was previously a less advantageous industry. Certainly, the gains of the investing country will be greater when the foreign industries developed by her capital exports are complementary to her own industries rather than competitive with them. When the lending and borrowing countries are in different stages of industrial evolution and have different natural resources and transport conditions, a capital transfer between them is more likely to call forth complementary branches of production in the capital-importing country.

Obviously, there will be no cheapening of imported goods if the foreign loans are applied to non-productive uses, such as court display, rearmament, or war.

A decrease in the domestic costs of production arising from the possibility of increased economies from a larger scale of production in the exporting industries cannot be predicted with any degree of certainty. Such a decrease in costs may not result. Dr. White argues that the increase in the foreign demand for the exports of the lending nation is not an additional, but only a substitute, demand; the transfer of purchasing power abroad that causes an increased foreign demand for the country's products decreases at the same time a domestic demand, or prevents an increase in the domestic demand.<sup>19</sup> There are reasons to anticipate, however, that certain industries in the lending country may benefit more if the capital is invested abroad than if it is invested at home. For one thing, the increase in the combined incomes of the two countries will be greater in the former case than in the latter. Again, industries for whose products the domestic demand has reached practically the

<sup>19</sup> White, *op. cit.*, p. 296.

## 682 International Trade and Commercial Policy

saturation point may experience a large increase in sales abroad, as new investments in backward countries succeed in raising the level of incomes there.

When defaults in debt payments occur, the national loss may well be greater where the debt is foreign than where it is domestic. Lord Keynes pointed out<sup>20</sup> that repudiation or failure in the case of foreign loans leaves nothing to the lending country, whereas in the case of domestic repudiation the tangible instruments of production do remain in the lending country. This criticism of Keynes's cannot be pushed too far. Once liquid capital has been converted into fixed capital, its value depends upon its earning power, and any diminution of this earning power represents a real loss of value in domestic investment as much as it does in foreign investment, even though in the former case the physical instruments of production remain within the country. But the earnings of an industry are a criterion of its value to the country only where the industry is privately operated and controlled. The default of a domestic public-service industry does not necessarily represent a loss to the nation equivalent to that sustained from a similar default of a foreign public-service corporation. The default may be due to a rate schedule that is too low, an excessive tax rate, poor financing, or excessive overhead. Any of these represents merely a transfer of wealth from one group to another within the creditor country. In such an instance, default entails at most only a slight national loss, whereas foreign default involves total national loss.<sup>21</sup>

*Terms of Trade.* Any calculation of the national gain, or loss, from foreign investment must take into account the effects of such investment upon the terms of trade, i.e., the quantity of imports received for a given quantity of exports. During the period when the loan is being transmitted, the terms of trade turn against the lender. But this unfavorable shift in the terms of trade is later balanced by an equal improvement in terms when, and if, the principal is repaid. Furthermore, the payment of interest has the same effect upon the terms of trade as the repayment of the principal. Consequently, in addition to the improvement in the terms of trade resulting from

<sup>20</sup> "Foreign Investments and National Advantage," *London Nation* (August 9, 1924), p. 584. Cited by White, *op. cit.*, p. 273.

<sup>21</sup> Cf. White, *op. cit.*, p. 274.

the repayment of principal, which can reasonably be assumed to equal the original worsening in terms at the time the loan was made, there is an improvement in the terms of trade that results from interest payments. Over the entire cycle of a foreign loan, therefore, the payments made to the lending country exceed those made to the borrowing country by the amount of the interest payments, provided that the original terms of the contract are fulfilled. This means that over the life-cycle of the loan the terms of trade tend, on the average, to favor the lending country. The lending country may conceivably experience a further improvement in the terms of trade from the lowering of the foreign costs of production that the capital export may effectuate.<sup>22</sup>

*Effects on the Volume of Trade.* Since capital must always be transferred between countries in the form of goods or services, it is obvious that capital-flows, while they are going on, must influence the international flow of commodities. But it is not possible to say beforehand how the total volume of international trade will be affected, for the lending nation can establish an export surplus not only through an increase in its exports, but also through a curtailment of its imports, or through a combination of the two. Nevertheless, where a backward country borrows in order to develop its productive powers, it is probable that its imports will increase more than its exports will decline, because such development will require foreign *goods* as well as foreign *funds*. The transmittance of a loan will here result in an increase in the volume of foreign trade.

The permanent effects of international capital movements upon the volume of international commodity trade can be predicted with no greater degree of certainty. A number of conflicting tendencies are at work. An increase in the combined social product of the creditor and debtor countries, such as international capital flows tend to foster, is likely to call forth a greater demand for foreign goods and services as well as for domestic goods and services, and thus to augment international trade. Furthermore, countries having rich natural resources, which they are unable to utilize properly so long as they have inadequate supplies of labor and capital, may be

<sup>22</sup> For a fuller discussion of the relations of the terms of trade to national advantage see Charles R. Whittlesey, "Foreign Investment and National Gain," *American Economic Review*, Vol. XXIII (1933), pp. 466-470.

## 684 International Trade and Commercial Policy

able to develop great export industries based upon these natural resources when sufficient inflows of labor and capital have taken place.

On the other hand, international movements of the productive factors (labor and capital) reduce the inequalities in the factor equipment of the countries concerned, and thus operate to bring factor prices in the different countries closer together. This narrowing of the international differences in factor prices contracts the very bases of international commodity-flows. The increase in the national income that results from an inflow of labor and capital, and the consequent growth of the domestic market, may, moreover, enable many domestic industries to realize the economies of large-scale production and reduce their costs of production to such an extent that commodities that were previously imported can now be produced just as cheaply at home as abroad. But these large-scale economies are not equally important to all industries. If such economies benefit the exporting industries more than they benefit the industries competing with imports, the result may well be increased foreign trade. Capital export may, finally, alter the demands for goods through its influence on the distribution of the national income. If demand turns strongly to foreign goods, international trade will tend to increase; if demand turns more largely to domestic goods, international trade will tend to decrease.<sup>23</sup>

*Development and Integration of a World Economy.* International capital movements have been an important factor in the development and integration of the system of economic relationships known as the "world economy." Over long periods of time, this integration has been achieved by an increasing uniformity in the tempo and direction of the capitalistic development of countries. For shorter periods, it is manifested in an increasing international parallelism in the cyclical behavior of business. Foreign borrowings contributed significantly to industrialization in the United States and the British Dominions in the latter half of the nineteenth century, and were indispensable to the industrialization that was beginning to get under way in the Far East and South America in the decades prior to the outbreak of the recent war. Exports of capital goods and technical knowledge have commonly accompanied ex-

<sup>23</sup> This general subject has been treated at length by Ohlin. See his *International and International Trade*, Ch. IX.

ports of capital. Future industrial developments in backward areas will continue to hinge upon an inflow of capital.

Capital export has been closely attuned to the activity of business. Periods of prosperity have also been periods of intensified capital export, while exports of capital have declined precipitously during periods of depression. In the nineteenth century the United States, South America, and the non-European countries within the orbit of British influence experienced prosperity simultaneously with Great Britain, as British capital flowed in generous amounts to these borrowing areas and led to speculative expansion. Depression in England, however, brought to a virtual stop this outflow of capital, and resulted in business reverses, depreciation of investments, and social unrest in capital-importing regions. In 1929-1931 the cessation of international capital-flows deranged the monetary systems of debtor nations, compelled them to readjust their foreign trade balances, and further aggravated the depression. The deepening of depression in debtor countries, in turn, reacted unfavorably on creditor countries. Drastic declines in both the volume and prices of exports, and defaults in payment of interest and principal on foreign investments, brought a shrinkage in incomes, a decline in production, and serious unemployment. Currencies, credit, and business may be further unsettled by flights of "hot money." Business cycles have become truly international in scope.

The tendency of capital exports to expand as business improves and to slump, or be reversed, when, or shortly before, general business conditions deteriorate has had the effect of accentuating rather than of softening industrial fluctuations. The League of Nations' Delegation on Economic Depressions has recommended that governments and the International Bank for Reconstruction and Development endeavor to bring about a contra-cyclical international flow of capital—i.e., encourage foreign lending when business slackens—as a means of counteracting depression.<sup>24</sup> Such a policy would benefit borrower and lender alike. It would prevent the savings of lenders from going to waste in depression and unemployment from developing. For foreign lending stimulates exports and tends to aid directly those very capital-goods industries which are usually the first to be affected by depression. Borrowing countries would benefit

<sup>24</sup> *Economic Stability in the Post-War World*, Ch. XIII.



## 686 International Trade and Commercial Policy

from such a policy by escaping strains on their foreign exchanges and, owing to the influence of such a policy on employment in lending countries, by the sustentation of demand for the products of agricultural and mining areas. Obviously, it is desirable that, whenever possible, foreign investment should take the form of equity or direct investment, so that a heavy foreign debt may not constitute an intolerable burden to debtor countries in times of falling prices. When this is not possible, elasticity might be provided in loan contracts by permitting accelerated amortization in periods of activity and a relaxation of amortization when transfer difficulties arise.

The difficulties of inducing foreign short-term and long-term lending during slack times are not, however, to be underestimated. Home investment, furthermore, is likely to be more efficacious than foreign investment in stimulating domestic employment, or in warding off a business slump. Foreign investment increases domestic employment only insofar as it stimulates exports. Because a portion, and in some instances a large portion, of foreign loans must be spent for labor and materials within the borrowing country, it is improbable that the immediate increase in the value of exports from the lending country will equal the value of the new loans. Moreover, foreign investment, unlike domestic investment, does not directly affect the domestic construction industry, the segment of the economy that is most prone to collapse. A dollar of investment at home will, in short, probably create a greater volume of domestic employment than a dollar of foreign investment.

### THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

The unhappy experiences of lenders and borrowers with international lending during the decade of the thirties convinced many scholars and statesmen that new policies and new techniques in the field of international lending were needed. To this end, articles of agreement for a new International Bank for Reconstruction and Development were adopted at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, in July, 1944, and attended by delegates from forty-four nations. By the end of December, 1945, the necessary number of signatory countries had ratified the agreement, and plans were under way to establish the

Bank and start it functioning in 1946. The purposes of the Bank are to increase the quantity and improve the quality of international lending; to assist in the reconstruction and reconversion of the territories of members that have been destroyed or disrupted by the war and in the development of productive facilities in the less developed territories of members; and to carry out the investment activities of the Bank in such a way as to contribute to the balanced growth of international trade and the maintenance of equilibrium in balances of payments.

The objective of the Bank is to complement and promote private foreign investment rather than to compete with it. Before the Bank can make a loan, it must be satisfied that "in the prevailing market conditions the borrower would be unable otherwise to obtain the loan under conditions which in the opinion of the Bank are reasonable for the borrower." The statement of purposes indicates that the primary emphasis should be placed by the Bank on guaranteeing loans made by private investors and on participating in private loans. Direct loans are to be made by the Bank only where private finance, with or without the assistance of the Bank, is not available on reasonable terms.<sup>25</sup>

The Bank obtains its funds from two sources: capital subscriptions and borrowings. The authorized capital of the Bank is ten billion dollars divided into 100,000 shares of \$100,000 each, and may be increased only upon agreement by three-quarters of the total voting power. Each member must subscribe to a pre-determined quota; subscriptions range from 31,750 shares for the United States down to two for Panama.<sup>26</sup> Two per cent of each quota is payable in gold or dollars within 60 days of the Bank's commencing operations; another 18 per cent is to be paid in the member's own currency and is subject to call in installments. This paid-up capital is available to the Bank for direct lending or for participation in loans. The remain-

<sup>25</sup> An analysis of the purposes, structure, and operations of the Bank is given in an article by Arthur Smithies, entitled "The International Bank for Reconstruction and Development," *American Economic Review*, Vol. XXXIV (December, 1944), pp. 784-797. The Bank Documents are published by the United States Treasury.

<sup>26</sup> Original membership was reserved only for the forty-four nations represented at Bretton Woods, but provision was made for the admission of new members. Of the authorized capital, 9,000 shares were reserved for new members.

## 688 International Trade and Commercial Policy

ing 80 per cent of the Bank's capital is subject to call by the Bank only when required to meet obligations of the Bank created by guarantees or borrowings. The Bank may raise funds for relending or participating in private loans by issuing its own bonds, but its total loans and guarantees are limited to 100 per cent of its unimpaired subscribed capital, surplus, and reserves.

The management of the Bank is ultimately vested in a Board of Governors. Each member is to appoint one governor and have 250 votes plus one for each share of stock held. The executive business of the Bank is carried on by twelve Executive Directors. Each of the five members having the largest number of votes<sup>27</sup> is entitled to appoint one director; the other seven directors are appointed by the remaining members according to a scheme of proportional representation. A president, who acts as chairman, is appointed by the Executive Directors. Amendments to the Agreement can only be made if approved by three-fifths of the members having four-fifths of the total voting power, and some amendments require unanimous consent. Within the latitude of the original Agreement, important changes, such as an increase in the authorized capital stock, require a three-fourths vote.

*Quality and Quantity of International Investment.* The quality of loans sponsored by the Bank will, of course, depend upon its administration. Many of its loans will be risky because the most urgent need for the Bank arose from the absence of adequate machinery for making long-term loans for the reconstruction of war-torn areas, and such loans are necessarily risky. Nevertheless, rules have been laid down to improve the quality of the Bank's loans. Only loans for specific projects of reconstruction and development can be made by the Bank, and the specific projects must be investigated by a committee appointed by the Bank, which shall include an expert for the borrowing country and one or more members of the technical staff of the Bank. The ability of the Bank to make loans at rates of interest lower than would otherwise be possible will reduce future burdens on the balances of payments of countries which otherwise would have been compelled to borrow at high rates, and will thus

<sup>27</sup> These five nations with their total subscriptions in millions of dollars are: United States, 3,175; United Kingdom, 1,300; Russia, 1,200; China, 600; France, 450.

minimize the danger of defaults due to transfer inabilities. An international institution such as the Bank, which can survey a wide segment of the whole field of foreign investment and which provides facilities for consultation between experts of both borrowers and lenders, is, furthermore, in a better position to direct the flow of foreign investment into channels consistent with the "balanced growth of international trade and the maintenance of equilibrium in balances-of-payments" than the individual private investor. Finally, by making funds available to borrowers on more reasonable terms and by reducing the risks of lenders, it is expected that the Bank's operations will increase the total flow of international investment.

*Protection of Balances of Payments.* The Agreement contains provisions designed to safeguard the balance-of-payments position of both lenders and borrowers. The Bank cannot borrow or guarantee without the consent of the member in whose market the loan is made and the member in whose currency it is payable. If a loan is made out of the Bank's capital in the currency of a member, the loan contract must provide that payment of interest and principal must be made in that currency, unless the member agrees to some other arrangement, and such funds cannot be re-lent without the member's consent. In no case shall the Bank's loans in any given currency out of borrowed funds exceed its borrowings in that currency. It is provided, furthermore, that if expenditures in the territory of a member, made possible by loans made or guaranteed by the Bank, weaken that member's balance-of-payments position, the Bank may repurchase part of the currency spent with gold or free exchange.

Fully as important as the provisions to safeguard the balance-of-payments positions of lenders are those designed to protect the international-payments positions of borrowers. If a borrower is suffering from acute exchange stringency, the Bank may agree to accept service payments on the loan in that member's own currency for periods not to exceed three years. This can provide effective relief for debtors who temporarily cannot meet their obligations because of cyclical depression. The Bank may also, in such cases, modify the terms of amortization or extend the life of the loan. Where the execution of the project for which the loan is made gives rise indirectly to an increased need for foreign exchange by the borrower,

## 690 International Trade and Commercial Policy

the Bank may, in exceptional circumstances, furnish the borrower with a limited amount of gold or foreign exchange to meet these needs; the extent of such relief, however, is not to exceed the local expenditure by the borrower in connection with the project.

*Soundness of the Bank.* At the time of its establishment, a substantial part of the Bank's capital was unquestionably ineffective. The subscription list contained the names of some countries the local currency of which nobody wanted to borrow and which were then incapable of implementing the Bank's guarantee function by furnishing free exchange to meet defaults. The original resources of the Bank must be regarded, then, as consisting only of the contributions of those countries whose balance-of-payments position or whose reserves of gold and free exchange enable them to fulfill their obligations. The real test of the Bank's soundness, however, is not so much the present position of member countries as their position fifteen or twenty years hence, when the bulk of the Bank's liabilities in the nature of guarantees will begin to fall due. The success of the Bank will thus depend on (1) the care with which it guarantees and makes loans, (2) the success of the world in achieving economic balance, and (3) the ability of various countries to accumulate adequate reserves.

The liabilities of members are, however, never likely to be substantial in any single year. First, postponement of the liabilities of the borrower is to be granted before calls are made on the guarantors. Second, the maximum call that can be made on members in any one year is limited to the amount of the annual service charges on the defaulted loans plus one per cent of total subscriptions. This spreading of the guarantors' liabilities should greatly assist guarantors in meeting their obligations.

Further protection to the Bank's capital is afforded by provisions in the Agreement that require any member to pay into the Bank an additional sum sufficient to maintain the gold or dollar value of the Bank's holdings of that member's currency in the event of its depreciation. The limitation on the loans and guarantees which the Bank may undertake at any one time to 100 per cent of its capital and surplus should also contribute to its soundness. By setting aside annually a portion of its earnings as a special reserve, the Bank may,

furthermore, accumulate over a period of years a substantial sum which is to be kept available for meeting its liabilities.

Doubt has been expressed in some quarters about the ability of the Bank to lend at substantially lower rates than private investors and at the same time to remain financially sound. Two features of the Bank support the opinion that this may be possible. First, because of its size and its connections, the Bank will be in a position to spread its risks more widely than any private investor. Secondly, the Bank need not take into account the risk of a single failure on the part of a borrower to meet his annual obligations, a defection that would seriously impair the value of a privately held security. Its freedom to provide relief for a debtor who cannot meet his obligation because of temporary embarrassment means that the Bank need only consider the longer-run position.

Critics have alleged that the effect of the Bank will be to place the resources of lenders at the disposal of an institution which is largely controlled by borrowers, and that this will work against the interests of the United States because in the early postwar period the United States must be the chief lender, and borrowing countries will have a majority of the Executive Directors. United States interests are, however, protected in two ways. The lending country has a veto power on any use of its currency by the Bank, with certain minor exceptions, and on any guarantees or borrowing operations of the Bank in its territory. The United States is further protected by the voting provisions of the Agreement, which require four-fifths of the voting power to approve amendments to the Agreement and a three-fourths vote to increase the capital stock. Possession of 28.8 per cent of the total vote gives the United States an effective veto.

The guarantee function of the Bank offers definite advantages to both lenders and borrowers. These were forcefully stated by the late Lord Keynes before the Bretton Woods conference:

. . . Only those countries which find themselves in a specially favored position can provide the loanable funds. But this is no reason why these lending countries should also run the whole risk of the transaction. In the dangerous and precarious days which lie ahead, the risks of the lender will be inevitably large and most difficult to calculate. The risk premium reckoned on strict commercial principles may be beyond the capacity of

## 692 International Trade and Commercial Policy

an impoverished borrower to meet, and may itself contribute to the risks of ultimate default. Experience between the wars was not encouraging. Without some supporting guarantee, therefore, loans which are greatly in the interests of the whole world, and indeed essential for recovery, it may prove impossible to float.

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## *International Monetary Relationships*

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Since World War I the monetary problem has become one of the world's most pressing economic problems. From the domestic point of view, the monetary problem has been thrust into prominence by war and postwar inflation and by the increasing public insistence upon economic stabilization. The severity and prolongation of the depression of the thirties, with its mass unemployment and lowered living standards, has made the mitigation of industrial fluctuations one of the major objectives of government policy throughout the world. Monetary policy is widely regarded as one of the most effective measures for the attainment of this end. Some monetary theorists believe that relatively full employment of resources may be achieved and maintained by the proper monetary policies, although unanimity of opinion on any specific policy has been lacking. Policies which have been recommended include the stabilization of some critical segment of the price level, the stabilization of per capita money incomes, 100 per cent reserves against all demand deposits, and the creation of money upon the basis of composite units of staple, storable, primary commodities. Even economists who do not have such confidence in the efficacy of monetary policy for attaining stability believe, nevertheless, that the proper monetary policies must be pursued if other policies are to succeed.

In a world of sovereign national states, monetary policy is a matter of national policy. Yet national monetary policies have broad international effects. A high degree of interdependence exists between the various national economies, an interdependence primarily of prices. This interdependence of national price systems is brought to a focus in the foreign exchange market, where international accounts are settled and the currencies of different nations are exchanged for

one another. Monetary policies which force prices and costs in any nation out of line with prices and costs in other nations, or affect the international flow of capital, changes in demand, the discovery of new resources or the exhaustion of old, or changes in the techniques of production create disequilibrium in the balance of payments. Disequilibrium affects first the foreign exchange market and is revealed by a rise or fall in foreign exchange rates, but it is eventually transmitted to banking, commercial, and industrial structures. The process by which disequilibrium in a nation's international accounts is corrected and internal prices are brought back into balance with prices in the rest of the world depends upon the nature of the relationships which exist between the national monetary systems.

International monetary relationships fall into two broad categories: those characterized by fixed foreign exchange rates, and those characterized by freely fluctuating foreign exchange rates. Adherence to the gold standard assures relative fixity of exchange rates, whereas the prevalence of independent paper currencies allows exchange rates to fluctuate freely over a broad range. The adjustment of international disequilibrium under either system involves changes in *relative* price levels. But the process by which these relative price changes are brought about and the effects of international adjustment upon internal prices and incomes differ in the two situations. In brief, the gold-standard system works through variation of internal prices and incomes relative to export-import prices, while the paper-standard system works through variation of the prices of exports and imports, and of other items comprising the balance of payments, relative to internal prices and incomes. These two compensatory mechanisms have been described at length in Chapters VIII and IX.

The satisfactoriness of an international monetary mechanism is to be judged upon the degree of success with which it achieves certain objectives. First, does it permit the maximum development of international trade in accordance with the principle of comparative advantage and foster the free flow of capital from nations of capital abundance to nations of capital scarcity? Any monetary system that compels governments to resort unduly to exchange and trade restrictions in order to protect their monetary structures or hampers the

## 696 International Trade and Commercial Policy

free flow of goods and capital cannot be deemed satisfactory. Second, does it allow individual nations sufficient freedom in the adoption of policies designed to counteract internal deflationary forces? A system that fails to secure a sufficient amount of freedom to member countries will not be acceptable. Finally, when international equilibrium is disturbed, does it let the necessary price adjustments take place smoothly and with a minimum of disturbance to national economies? The chief problem of international policy is, in other words, how to prevent the occurrence of world booms and depressions and how to enable individual countries to protect themselves from such disturbances that may arise in the outside world, and at the same time to retain the advantages of international trade and international capital movements.

The international gold standard insures the stability of foreign exchange rates, and thus facilitates the international purchase and sale of goods and the international movement of capital. But, under present economic, social, and political conditions, necessary international price adjustments under the gold standard may cause serious disturbance to national economies, and the pursuit of autonomous credit and policies may endanger a nation's very ability to adhere to the standard. A system of independent paper currencies, on the other hand, allows wide leeway in following nationalistic credit and economic policies and permits the adjustment of international disequilibria with a minimum of disturbance to national economies. Under independent paper currencies, however, exchange rates may fluctuate widely, and widely fluctuating exchange rates tend to interfere with the international flow of goods and capital.

We thus face the dilemma of internal stability or external stability. An international monetary mechanism that insures stable exchange rates limits the individual nation's independence of action and forces disturbing adjustments on any nation that gets out of step with the rest of the world, while one that allows freedom in internal management does so at the expense of unstable exchange rates. Unless the nations of the world can attain substantial unity in their internal policies, a contingency which appears remote, it seems clear that the international monetary problem must be conceived in terms of compromise. A return, in the postwar period, to the inflexible exchange rates of the old gold standard may again saddle the world with

exchange control and other discriminatory practices. Failure to make the slightest concession in national monetary and credit policies, on the other hand, may cause the system to lose every trace of exchange stability and multilateralism.<sup>1</sup>

It is the task of the present chapter to analyze and appraise various experiments with, and proposals for, an international monetary system.<sup>2</sup>

### THE GOLD STANDARD

The gold standard mechanism was the world's closest approach to an international monetary system. During the half century preceding the first World War, the gold standard worked smoothly and contributed significantly to the growth of trade and investment. It was, in this way, a powerful factor in the development of the world's productive powers and the improvement of living standards. So successful had the gold standard been during this period that most of the nations of the world, which had been forced to abandon the gold standard during the war, strove to return to it, in some form, after the war. But the chaos in international monetary relations in the inter-war period—revealed in inflation, deflation, reckless lending and borrowing, competitive currency depreciation, exchange controls, trade barriers, and bilateralism—caused the gold standard to undergo searching and critical examination, from which it emerged with a sadly tarnished reputation.

The gold standard integrates the currency systems of member countries by (1) maintaining relatively stable foreign exchange rates, and (2) keeping price levels in line with one another. It is a truly international system. The relative stability of exchange rates is assured by the obligation of the treasury, or central bank, at home and abroad to buy and to sell gold in unlimited amounts at fixed prices in terms of local currencies. Whenever the price level of any

<sup>1</sup> International trade is multilateral when "each nation can be assured of facilities for spending in one part of the world what it is earning in some other part of the world." D. H. Robertson, "Post-War Monetary Plans," *Economic Journal*, Vol. LIII (December, 1943), p. 353.

<sup>2</sup> Dean John H. Williams has presented a suggestive list of possible international monetary systems progressing from the automatic gold standard to the automatic paper standard in the article, "The Adequacy of Existing Currency Mechanisms Under Varying Circumstances," *American Economic Review*, Supplement, March, 1937, pp. 151-168.

## 698 International Trade and Commercial Policy

country gets out of line with prices in the outside world, the adjustment mechanism operates upon prices both within and without the country in such a way as to restore price equilibrium. The functioning of the gold standard presupposes, however, that the monetary authorities of the member countries are willing and able to play the gold-standard game according to its rules, even if to do so interferes with the aims of domestic credit policy.

When a country's purchases of goods, services, and securities from other countries are not completely offset by sales of goods, services, and securities to other countries, the restoration of international equilibrium is supposed to be accomplished automatically by the effects of short-term capital movements and gold-flows upon the economies of both the deficit and the surplus countries. In the country with the balance-of-payments deficit, the excess of the demand for foreign exchange over the supply of exchange will force the rate up toward the gold export point, lead to an inflow of short-term funds, and cause a contraction in the domestic monetary circulation. The contraction of the monetary circulation will reduce incomes and expenditures, and tend to lower prices and wages. In the countries with the balance-of-payments surplus, similar, but opposite, effects will appear. The excess of offerings of foreign exchange over the demand for exchange will lower exchange rates, lead to an expansion in the monetary circulation, and to larger money incomes and expenditures. Prices and wages will tend to rise. The combined effects of these changes will be to curb imports into, and stimulate exports from, the deficit country, for a part of the reduction in expenditures in that country will fall upon goods which it formerly imported, while a portion of the increased expenditures in the surplus country will be made on goods imported by it.

If the income changes and price changes bring about an alteration in the flow of commodities sufficient to restore equilibrium in the balance of payments, no gold need flow. If, however, equilibrium is not readily established, gold will be exported from the deficit country to the surplus countries in order to fill the gap in the balance of payments, and will continue to flow as long as disequilibrium in the balance of payments persists. Central bank policies which seek to counteract monetary contraction in the deficit country or monetary expansion in the surplus countries will retard adjustment,

and will cause a continuation of the gold drain from the deficit country. The deficit country will therefore be compelled eventually to institute a policy of deflation, impose control over the foreign exchanges, or abandon the gold standard, as its gold reserves become exhausted.

The adjustment of international disequilibria under the gold standard thus operates through changes in money incomes, expenditures, prices, wages, and other costs. The mechanism of adjustment is set in motion by the flow of short-term funds and/or gold. Where disequilibria are slight and temporary, the flow of short-term funds may be sufficient to restore equilibrium without the necessity of income and price changes. But deep-seated disequilibria can be corrected only by an altered international flow of goods. Income and price changes are essential for accomplishing this.

*Essential Conditions.* The smooth and successful working of the gold standard presumes the existence of certain conditions. (1) The world demand for exports must be elastic. Where the demand for a country's exports is elastic, a rise of domestic prices results in a decline in the value of a nation's exports, and a fall of domestic prices results in a rise in the value of its total exports. Such changes in exports are indispensable for a smooth adjustment.

(2) There must be sufficient flexibility of the cost-price structures of member countries. Prices and costs, especially wages, should be adjustable both upward and downward.

(3) National monetary circulations should be sensitive to gold-flows, i.e., losses of gold should cause a contraction of the currency, acquisitions an expansion. Whether an export of gold will compel a contraction of loans and deposits, and an import of gold lead to an expansion of loans and deposits, will depend upon the presence or absence of excess reserves in the banking system and upon the policy of the central bank. Gold-flows may have little effect on the volume of bank credit outstanding when the banks possess reserves well in excess of their legal or traditional requirements. But, even if the banking system is "loaned up," gold-flows will have no effect on the volume of bank credit if the gain or loss of gold is offset by open-market sales or purchases by the central bank. Experience shows that an outflow of gold is more likely to lead to a contraction of credit than an inflow is to cause an expansion of credit.

## 700 International Trade and Commercial Policy

(4) Goods should readily follow international movements of capital. Otherwise, an export of capital will impose an unbearable strain upon gold reserves.

*Why the Gold Standard Worked Before 1914.* The chief guide of central bank policy before 1914 was the protection of a country's gold reserves. This policy operated to supplement and strengthen the automatic functioning of the gold standard. An external drain of gold caused the central bank to raise its rediscount rate and, at times, to sell bills in the open market. The tightening of credit tended to deflate domestic incomes and prices, and led to an inflow of short-term capital. An inflow of gold, on the other hand, brought a relaxation of credit controls. The export of long-term capital in this period was confined to a few mature nations, and was motivated primarily by the desire of less developed nations to purchase goods in these older countries. International movements of short-term capital served mainly to place foreign exchange reserves at the disposal of countries that were, at the moment, in need of them—they were of the equilibrating type. Although tariffs were not uncommon, they were in general not excessive and were relatively stable. Other trade restrictions were rare. Some rigidity did exist in the price structure, but, on the whole, prices and costs, especially wages, retained sufficient flexibility to enable the necessary adjustments to take place without placing undue strain upon monetary structures.

Professor Hansen suggests further that the successful functioning of the pre-1914 gold standard was "greatly facilitated by the circumstance that it operated in a rapidly expanding economy and under the favorable conditions of an upward trend in prices. Maladjustments can more easily be corrected in a society which is rapidly reaching out into new areas, developing new resources, creating new industries, and supplying the needs of an increasing population. Maladjustments can also be corrected more easily in a society enjoying high investment activity and moderately rising prices."<sup>8</sup>

*Shortcomings of the International Gold Standard.* This favorable conjuncture came to an end with the outbreak of the first World War. The dislocations caused by the war, the struggle throughout

<sup>8</sup> Reprinted from *Full Recovery or Stagnation?* by Alvin H. Hansen, p. 210, by permission of the publishers, W. W. Norton & Company, Inc., New York. Copyright, 1938, by the publishers.

the world to achieve economic stability, the strengthening of the spirit of nationalism, the failure to attain effective international cooperation, and, finally, the catastrophe of world-wide depression combined to form a political, social, and economic environment in sharp contrast to that of the prewar period, and one that was quite unpropitious for the effective functioning of the international gold standard. In this new environment, shortcomings in the gold standard appeared which were not apparent in the more favorable pre-1914 environment. Nations which attempted to adhere to the standard and maintain their former parities, once depression settled upon the world, were subjected to intolerable deflation, and were compelled eventually to devalue their currencies or to abandon the gold standard. The unhappy experiences of most nations with the gold standard in the inter-war period have done much to undermine public confidence in the standard and to make a return to the prewar automatic gold standard highly improbable.

Foremost among the changes that have hampered the functioning of the international gold standard is the reappraisal of monetary policy. No longer is the major objective of central bank policy considered to be the safeguarding of the nation's gold reserves. The primary responsibility of the central bank is deemed to be, rather, the maintenance of economic stability, i.e., the avoidance of booms and depressions, with their extreme fluctuations in employment and production. But the maintenance of internal stability at times necessitates breaking the rules of the gold-standard game. An inflow of gold is evidence of an international disequilibrium; correction of the disequilibrium decrees an easy money policy and an expansion of credit. Such a credit expansion may not, however, be welcomed by the monetary authorities, who may regard domestic conditions as already dangerously inflationary. They will consequently counteract the inflow of gold by appropriate credit policies, e.g., a higher rediscount rate, the sale of securities by the central bank, an increase in the legal reserves of member banks, or moral suasion. Where such a policy is pursued, the complete burden of international adjustment is shunted on to the deficit country, and the deflation of incomes and prices in that country must therefore be all the more severe. If the monetary authorities in the deficit country are also endeavoring to stabilize production and employment, and therefore



## 702 International Trade and Commercial Policy

offset the loss of gold by a credit expansion, international disequilibrium will persist. The country will consequently continue to lose gold until the central bank is no longer able to maintain specie payments. Adjustment will then be accomplished by a sharp depreciation of the external value of the country's currency, or by the restriction of imports through exchange control or other trade barriers.

Adherence to the gold standard narrowly limits the scope for independent domestic action. It forces the national monetary authorities to subject their domestic credit and fiscal policies to international dictation.<sup>4</sup> An inflationary domestic credit and fiscal policy designed to expand production and increase employment may, for example, have to be abruptly and prematurely terminated because of a heavy external drain of gold, caused by the failure to hold the domestic cost-price structure in line with the world structure. At a time when national governments have learned to regard their credit and spending policies as indispensable weapons of economic policy, there has evolved an increasing unwillingness to subordinate these policies to outside dictation, as they must, to a considerable degree, under an international gold standard.

A second condition which has been unfavorable to an international gold standard is the growing rigidity in cost-price structures. This rigidity is attributable to many different factors, chief among which are monopoly, oligopoly, product differentiation, valorization schemes, the growth in the power of labor unions, minimum-wage laws, unemployment insurance, government regulation of prices, and the increase in public debts and public services, which has meant higher and relatively inflexible taxes. Inflexible cost-price structures are particularly resistant to downward adjustment. Deflationary policies are consequently liable to cause unemployment rather than to produce the desired lower levels of prices and costs.<sup>5</sup>

<sup>4</sup>The dictation may be that of the average behavior of the group of nations, or that of the behavior of a leader country. Much of the pre-1914 success of the gold standard is to be attributed to the experienced leadership of England, which held a position of predominance in world banking. Cf. George N. Halm, *International Monetary Cooperation*, pp. 16-18.

<sup>5</sup>It should be remembered that capital movements and income changes also play major roles in the adjustment of international disequilibria under the gold standard. Where the disequilibrium is not too serious, only minor price changes may be necessary.

The functioning of the gold standard has also been impeded by trade restrictions. Protective tariffs were, to be sure, almost universally employed before 1914. But national tariffs were relatively stable, and were not subject to frequent and drastic upward revision. Tariffs were projected with the established objective of providing "necessary" protection for domestic industry. In the inter-war period, however, tariff increases were frequent and sharp, and were buttressed by other even more effective instruments of restriction. Trade restrictions were used more and more to cope with disturbances in the balance of payments, so that basic adjustments were obviated—at the expense of international trade. The increase in tariff rates by the world's chief lending nation in 1930 did much to intensify deflation in debtor countries and to undermine the gold standard.

The gold standard has not always proved a reliable corrective mechanism for international capital movements. Capital movements present two problems—a cycle problem and a crisis problem.<sup>6</sup> Cyclically, they may hinder internal control by the monetary authorities. A boom in a given country, with its rising prices and profits, tends to attract capital more rapidly than goods, so that gold flows into the country and encourages a further rise in prices. A restrictive central bank policy may be neutralized by a further inflow of short-term funds from abroad, attracted by the higher interest rates. Capital may also be the vehicle of world-wide booms and depressions. Capital movements during a boom lead to expansion in capital-importing countries and to highly prosperous export trade in the capital-exporting countries. The cessation of capital movements and the burden of fixed interest charges produce depression in the capital-importing countries, which may then spread back through the channels of trade to the capital-exporting countries. In times of political and economic unsettlement, short-term capital movements, instead of performing their traditional function of facilitating the adjustment of international disequilibria, may themselves become an additional element of disturbance which may endanger the very existence of the gold standard. A rise in the rediscount rate is usually impotent to prevent a panicky flight of short-term capital, a phenomenon which is analogous to an internal run on the bank.

<sup>6</sup> See John H. Williams, *op. cit.*, pp. 154–156.

## 704 International Trade and Commercial Policy

The international run can be stopped only by the institution of foreign exchange control. Unless it is stopped, it will force abandonment of the gold standard. Only a nation with large gold reserves can long sustain such an outflow of capital.

Some students suggest that the gold standard suffers from an inherent bias toward deflation. Gold-losing countries must contract credit in order to maintain their gold reserves, unless they can afford to lose gold or are willing to go off the gold standard. Gold-receiving countries, however, are under no compulsion to expand credit in order to halt the inflow of gold. Even when business expansion appears desirable, the monetary authorities may be unable to generate expansion if the business community is disinclined to expand. Professor Williams offers two more reasons for the one-sided deflationary operation of the gold standard.

One is the unequal importance of the balance of payments as between countries whose foreign trade and other payments are large relative to the home economy and countries for which foreign trade is less important. The other is the unequal size of countries. Gold standard theory was based on the principle of interaction between homogeneous countries of approximately equal size . . . a large export surplus (for the United States), or any other change leading to substantial gold inflow, would be likely to have far less expansive effect here than contractive effect upon the deficit countries.<sup>7</sup>

The gold standard mechanism usually works satisfactorily when only modest disequilibria are to be adjusted. It is in times of political and economic stress, when the deflationary policies prescribed by the rules of the game turn out to be politically unfeasible and socially unbearable and when public confidence in the future of currencies becomes shaken, that the mechanism tends to break down.

### FLEXIBLE EXCHANGES

The adjustment of international disequilibria involves, basically, the same changes under a system of independent paper currencies that it does under the gold standard—namely, changes in the international flow of goods and services. But the mechanism differs in the

<sup>7</sup> "The Post-War Monetary Plans," *American Economic Review*, Supplement, March, 1944, pp. 373-375.

two situations. Under the gold standard, the necessary alterations in the flow of goods are brought about by an international transfer of purchasing power, made possible by the flow of gold or short-term capital and by changes in money incomes and prices in the countries concerned. Under a system of independent paper currencies, on the other hand, the requisite changes in the flow of trade are induced primarily by variations in foreign exchange rates and in the price structure of the balance of payments, with a minimum of disturbance to incomes and commodity prices.

When currencies are not convertible into gold at fixed mint prices, fluctuations in foreign exchange rates are not confined within the narrow limits of the gold points; they may be very wide. The possibility of wide variations in foreign exchange rates deters equilibrating movements of short-term capital; and, when neither gold nor short-term capital moves in response to changes in the balance of payments, no international transfer of purchasing power is possible. Without such a transfer of purchasing power, there will be no general change in national incomes or national price levels to affect the international flow of commodities. The initial disturbance in the balance of payments will therefore cause a sharp depreciation of the deficit country's currency in the foreign exchange market, and this currency depreciation will curb imports into the deficit country and encourage exports from it, to the extent necessary to bring demand and supply in the foreign exchange market to an equality. The requisite *relative* changes in national price levels are thus effected not by absolute changes in national price levels, but merely by changes in the prices of foreign currencies.

*Advantages.* From the international standpoint, flexible foreign exchanges possess certain advantages over fixed exchanges. The correction of balance-of-payments disequilibria is accomplished largely through changes in exchange rates and in the price structure of the balance of payments, with a much smaller disturbance to internal economies than is required under the gold standard. The deficit country is not forced to suffer general deflation, which may result in serious unemployment when cost-price structures lack sufficient flexibility; nor is the surplus country compelled to undergo unwanted general inflation. This is not to say, however, that international disturbance has no disturbing effects upon internal economies

## 706 International Trade and Commercial Policy

when exchanges are flexible. The fluctuations in exchange rates cause import and export prices to rise in the deficit country and to fall in the surplus country, while the shifts in spending, induced by relative changes in national price levels, give rise to some shifting of the productive factors among industries in both countries. But the internal disturbances are less than they are under gold because they are not supported by expansion, or contraction, in the monetary circulation and money incomes.

Flexible exchanges also allow the monetary authorities greater latitude in credit policy. There is little danger that an expansionary policy designed to increase production and employment will be brought to an untimely end by an outflow of gold; whenever domestic prices outrun world prices, the two will be forced into line by changes in exchange rates. Nor is a policy of internal stabilization apt to be upset by a favorable shift in the balance of payments, for no gold will flow in to enlarge the credit base. Professor Williams has suggested that exchange variation may further internal monetary control in yet another way: by protecting it from external interference in the form of international capital movements. Since exchange variation operates directly and powerfully against capital movements, it is not likely that the effects of discount-rate changes or open-market operations will be nullified by international capital movements, as they often are under the gold standard.<sup>8</sup>

*Disadvantages.* But flexible exchanges also have disadvantages. Although exchange rates under flexible exchanges may remain relatively stable over fairly long periods of time, there is always the chance that they may fluctuate violently. The prospects of violent fluctuations are detrimental to the international movement of commodities and capital. Any reduction in the volume of international trade or international lending is to be abjured, because it will restrict international specialization and impair living standards.

How fluctuating exchanges tend to restrict international trade may be simply illustrated. Consider the case of an American automobile manufacturer who contracts with an English purchaser for the delivery of 10 automobiles. If the American manufacturer's domestic selling price is \$1000 a car, and if the rate of sterling

<sup>8</sup> "The Adequacy of Existing Currency Mechanisms Under Varying Circumstances," *ibid.*, p. 155.

exchange is \$5 to the pound, the American can realize his domestic selling price by charging the Englishman a price of £200 a car. If, however, the cars are not to be shipped and a bill of exchange drawn until two or three months later, the American manufacturer stands to lose if the sterling rate falls in the meantime to, say, \$4.50 to the pound. He will then realize from the sale of his bill of exchange only \$9000, which is \$1000 less, on the entire shipment, than he could have realized from the sale of the cars in the domestic market. Of course, he would stand to gain if the rate, instead of falling, rose. But, in any event, there is added to the ordinary commercial risk a risk of exchange which, unless it can somehow be eliminated, will deter many businessmen from undertaking international transactions. The American seller can, to be sure, avoid the risk of exchange by insisting that payment be made in dollars. This, however, does not eliminate the risk; it merely shifts it to the English importer and tends to dampen the latter's enthusiasm for the transaction.

There is available to traders a means of avoiding possible losses from fluctuations in exchange rates: they may hedge their purchases and sales of commodities by purchases or sales of forward exchange. By such action, the trader is assured of receiving, or paying, a specified price for the foreign bill that he must sell, or buy, at some future time, and he can fix the price in the commodity contract accordingly.<sup>9</sup> Unfortunately, contracts in forward exchange can be entered into only in the leading money markets of the world and are available only in the leading currencies, so that not all of the world's trade can be hedged by forward-exchange transactions. The smooth functioning of the forward exchange market depends, furthermore, upon the freedom with which short-term capital movements can take place. Consequently, when governments restrict the international movements of capital in periods of political and economic unsettlement, forward exchange rates go to sharp discounts, or premiums, relative to rates for spot exchange; and the prices that exporters must then charge become so high that they seriously curb foreign trade.

Exchange variation may be even more detrimental to foreign lending than to foreign trade. If the loan contract is written in terms of the borrower's currency, any depreciation of that currency rela-

<sup>9</sup> The reader is referred back to the analysis of forward exchange in Ch. IV.

## 708 International Trade and Commercial Policy

tive to the lender's will involve the lender in losses on both interest and principal account. Because of the prospects of such losses from exchange depreciation, lenders will judge foreign loans to be unattractive, unless they can be made at rates of interest high enough to compensate for the added risk of exchange. But borrowers may be unwilling to borrow on such unfavorable terms.

Lenders can, to be sure, avoid the risk of exchange by having the loan contract written in terms of their own currency. This is the usual practice. Where this is done, however, the risk of exchange is not removed; it is merely shifted to the borrower, who may be no more willing to assume such a risk than the lender. If the borrower's currency depreciates, the burden of the payments for interest and principal is increased for the borrower, and this increase in the debt burden may become an insurmountable obstacle to repayment. With flexible exchanges, furthermore, the very receipt and repayment of the loan tend to impose financial losses upon the borrower. The transmittance of the loan tends to depress the external value of the lender's currency, which the borrower at that time has for sale; while the payment of interest and the repayment of the principal tend to raise the external value of the lender's currency, which the borrower at the later dates is compelled to buy. The borrower, in short, receives a currency that is cheap and has to repay later a currency that is dear.<sup>10</sup>

Exchange variation has a less deterring effect upon direct investment. Much direct investment arises from the export of materials and equipment, and thus does not necessitate the purchase of foreign exchange. In the case of direct investments, furthermore, there is no obligation to remit interest or to repay the principal at stipulated dates. Whenever exchange rates are unfavorable for remittance, earnings may be left in the debtor country and need not be

<sup>10</sup> Professor Charles R. Whittlesey points out that, where the demand for the borrower's exports is elastic, the repayment of the loan need cause no serious depreciation of the borrower's currency, nor involve the borrower in difficulties; for a small depreciation will lead to a sharp increase in exports. *International Monetary Issues*, New York, 1937, Ch. VII. Some depreciation is, however, inevitable. Exchange depreciation does add to the financial costs of the loan, and it is in money terms that the calculations of lenders and borrowers are made.

repatriated until rates become more favorable. Losses cannot, of course, be avoided where depreciation becomes permanent.

Although exchange variation discourages capital movements that are induced by interest-rate differentials, and thus strengthens the control of the monetary authorities, it may aggravate flights of capital once they have set in. A flight of capital drives down the price of a country's currency in the foreign exchange market when currencies are not secured to gold, and the falling exchange rate itself incites further capital flight. For the public is prone to interpret exchange depreciation as the forerunner of domestic inflation. The export of capital is one way of safeguarding the purchasing power of domestic funds. Capital flight can, to be sure, cause the abandonment of the gold standard and eventual exchange depreciation. But alarm over the safety of a currency is apt to be less widespread as long as the currency is convertible into gold than it is when the currency is actually undergoing external depreciation.<sup>11</sup>

#### EXCHANGE STABILIZATION FUNDS

No nation has found completely free exchanges to its liking. Exchange variation not only tends to discourage international trade and international lending, but, because of its effects upon export and import prices, it also causes disturbing shifts in demands, production, and employment, both at home and abroad. Currency depreciation may give a country a temporary advantage in export markets. But when it is practiced by a country important in world trade, it exerts severe deflationary pressure upon other countries; and, since this is a game at which more than one nation can play, competitive currency depreciation frequently ensues.

Stability of foreign exchange rates has been judged to be of such importance for both external and internal stability that many nations which had divorced their currencies from gold during the thirties undertook to control temporary movements of exchange rates by

<sup>11</sup> Public confidence in gold is still strong, despite price instability under gold and recurrent departures from the gold standard. Experience with irredeemable paper currencies has, upon occasion, been unhappy. The most catastrophic inflations have occurred when governments have not been under the obligation of redeeming their currencies in gold. Gold is a refuge from the most violent storms of inflation.



## 710 International Trade and Commercial Policy

establishing exchange stabilization funds. At the time of the outbreak of the second World War, stabilization funds were employed by Great Britain, the United States, France, the Netherlands, Switzerland, and various other nations. Stabilization funds consist of financial resources placed at the disposal of the central bank, or some government agency, to be used in counteracting abnormal changes in demand or supply in the foreign exchange market. The resources necessary for the functioning of a stabilization fund are of two general classes: (1) foreign balances, or gold, with which either foreign balances or local currency may be acquired, and (2) local currency, or treasury bills, which may be sold for local currency or gold.

The operation of exchange stabilization funds during the thirties revealed that these funds are of two distinct types: the gold type and the credit type.<sup>12</sup> The Stabilization Fund established in the United States in 1934 is an example of the former type, and the British Exchange Equalisation Account, established in 1932, is an example of the latter. A description of the functioning of the American and British funds will indicate the basic difference between the two types.

The original resources of the American Stabilization Fund, a Treasury agency, consisted of two billion dollars in gold, a major part of the government's profit from the devaluation of the dollar. Whenever the Fund wants to support a weak foreign currency, it deposits gold certificates with the Federal Reserve Bank of New York and draws checks against this deposit to purchase the foreign currency in the exchange market. The Fund, in effect, exchanges gold for foreign balances, and by so doing prevents the dollar from appreciating against the foreign currency. If it is deemed undesirable to accumulate too large a balance abroad, a portion of the foreign balance can be used to buy gold in the foreign market. Whenever, on the other hand, the Fund desires to prevent the depreciation of the dollar, it can export gold, sell the gold abroad for foreign bank deposits, and sell these foreign balances in the exchange market. By thus surrendering gold for dollar balances, the Fund gives direct support to the dollar.

<sup>12</sup> See C. P. Kindleberger, *International Short-Term Capital Movements*, Ch. XII, for an able account of the operation of exchange funds.

A stabilization fund of the gold type can hold exchange fluctuations within any desired range by supplying foreign bills when exchange rates tend to rise and by buying bills when rates show a tendency to weaken. The gold-type fund does not, however, prevent international disturbance from producing in the money market effects similar to those experienced under the gold standard. When the American Fund buys foreign bills with Federal Reserve Bank balances, it places Federal Reserve funds at the disposal of the banking system and thus eases the money market. When it sells foreign bills to importers or commercial banks and builds up its deposits with the Federal Reserve Bank, it reduces by that amount the reserve balances of the banking system and tightens the money market. The moderation of exchange-rate fluctuations is achieved by the international gold standard; and, under a system of independent paper currencies, the same end could be attained by the central bank. The chief contribution of a stabilization fund of the gold type appears to be the preservation of secrecy regarding imports and exports of gold, since such funds are not usually required to publish reports.

It is in respect to the effects of their operations upon the money market that the main distinction between the gold-type and the credit-type stabilization funds lies. A description of the operations of the British Exchange Equalisation Account will make clear this difference between the two types of stabilization funds. The original assets of the British Account consisted of Treasury bills.<sup>13</sup> When the external value of sterling is rising, as the result, for example, of an inflow of foreign funds, the Exchange Equalisation Account may restrain the advance in the sterling rate by selling Treasury bills to the commercial banks and the money market and by purchasing foreign exchange with the sterling deposits received therefrom. The purchase of foreign exchange supports the price of the foreign currency, just as a purchase of exchange by a gold-type fund does. But, whereas the purchase of foreign exchange by the American Fund releases Federal Reserve Bank funds to the commercial banks and thus enlarges the credit base of the member banks, the operation of the Exchange Equalisation Account causes no such enlarge-

<sup>13</sup> The Account started with 150 million pounds of Treasury bills. This amount was later increased.

## 712 International Trade and Commercial Policy

ment of the credit base. The sterling deposits with which the British Account buys the foreign exchange are first taken from the money market by the sale of Treasury bills and are then returned to it via the sellers of foreign exchange. There is no increase in the reserves of member banks nor in the monetary circulation;<sup>14</sup> the funds turned over to the sellers of foreign exchange by the Account are the same funds that were previously taken from the money market through the sale of Treasury bills by the Account.

When an outflow of funds threatens to cause a depreciation of sterling, the Exchange Equalisation Account can sell Treasury bills to the Bank of England for gold, export the gold in exchange for foreign balances, and sell the foreign balances for sterling deposits in London. By such action, the Account supports sterling in the foreign exchange market and at the same time prevents any loss of reserves by the commercial banks.<sup>15</sup>

The virtues of the gold-type fund are limited to the mitigation of fluctuations in foreign exchange rates. The operations of the credit-type fund not only control variations in the foreign exchanges, but they also insulate the money market from the effects of abnormal international payments, either inward or outward. The impotence of the American Stabilization Fund to neutralize the effects of large inflows of foreign capital upon the money market led the American monetary authorities in 1936 to adopt a procedure similar to that followed by the British Exchange Equalisation Account. Heavy inflows of gold into the United States in 1935 and 1936 had so increased the reserves of member banks that by September of the latter year excess reserves exceeded three billion dollars. In order to prevent further imports of gold from counteracting the higher reserve requirements imposed by the Federal Reserve authorities, the Treasury in December, 1936, began to sell government securities to commercial banks and to use the resulting deposits to purchase

<sup>14</sup> This is not quite accurate. To the extent that the Treasury bills sold by the Account are bought by the commercial banks, there is an addition to total deposits; but this is limited to the amount of the Treasury bills purchased by the commercial banks. Member bank reserves are not increased, and the multiple expansion of bank deposits is thus prevented.

<sup>15</sup> The money market does lose the deposits paid over to the Account by the purchasers of foreign exchange. But the commercial banks do not lose an equal quantity of reserves as they do under the American-type fund.

new imports of gold. Gold imports were thus prevented from enlarging member bank reserves. This policy was later discontinued.

Stabilization funds can, with ease, maintain exchange stability for independent paper currencies in the face of short-run disturbing influences, provided their resources are ample. They can do this and at the same time prevent international disturbances from reaching into the domestic economy if proper money market policies are coupled with their exchange-stabilizing operations. But they cannot preserve exchange stability indefinitely in the face of deep-seated disequilibria unless international equilibrium is restored. A stabilization fund which insists upon maintaining stable exchange rates when, for example, the domestic price level is too high relative to world prices will sooner or later find its reserves of foreign exchange and gold exhausted. It will then be unable to preserve exchange stability any longer. What is needed is a basic adjustment. If it is desired to maintain stable exchange rates, domestic prices and costs must be deflated. If it seems preferable not to suffer internal deflation, the external value of the currency must be permitted to depreciate to the equilibrium level. Currency depreciation will usually be the more politically feasible course.

*The Tripartite Currency Agreement of 1936.* The persistence of France, Belgium, Switzerland, and the Netherlands in maintaining their currencies at the old gold parities after England and the United States had depreciated their currencies in 1931 and 1933, respectively, resulted in an overvaluation of the currencies of the former (Gold Bloc) countries and heavy pressure on their price levels and export trade. The widespread belief that eventually these Gold Bloc countries would have to cut the gold content of their currencies caused a persistent flight of capital, which added to the currency troubles of these countries. Belgium finally devalued the belga by 28 per cent in April, 1935, and France formally abandoned the gold standard in September, 1936. The French devaluation caused the Netherlands and Switzerland immediately to suspend gold payments.

The currency devaluations of the Gold Bloc countries threatened to precipitate a series of competitive devaluations. To forestall such an eventuality the United States, Great Britain, and France announced in September, 1936, that they had concluded an agreement,

## 714 International Trade and Commercial Policy

which came to be known as the Tripartite Currency Agreement, according to which these countries agreed to cooperate in the stabilization of exchange rates among their currencies. Switzerland, Belgium, and the Netherlands soon joined the accord. Each party to the agreement expressed the intention of using appropriate available resources in order to avoid, as far as possible, any disturbance of the stability of their respective currencies, and expressed the hope that no country would attempt to obtain unreasonable competitive exchange advantage and thereby hamper the effort to restore more stable economic relationships. The exchange stabilization funds of the member countries cooperated to maintain exchange stability; presumably no member was to indulge in exchange depreciation without prior conference with the other parties to the agreement. The agreement became a dead letter with the occupation of France and the other Continental members by the German army in 1940.

The Tripartite Agreement represented a step forward—away from complete monetary nationalism and toward monetary internationalism. It recognized that monetary policy is not evolved in a national vacuum, that domestic monetary policies react upon foreign economies, and that the monetary policies of foreign nations react upon the domestic economy. The Tripartite Agreement was a beginning in international monetary cooperation—but it was only a beginning.

### INTERNATIONAL MONETARY COOPERATION

An acceptable international monetary system must allow member countries sufficient freedom of action to adopt those policies which are considered necessary for full employment. No government can today expect to endure for long in the face of mass unemployment if it is unable to convince the electorate that it has taken every possible measure to cure the malady. But national full-employment policies must be compatible with international cooperation and a reasonable degree of exchange stability. An international monetary system cannot be expected to function successfully unless the nations of the world are willing to follow accepted rules of international behavior, even if these rules at times necessitate the compromising of purely domestic policies. National credit and

employment policies that are heedless of international repercussions are doomed to eventual failure, for few nations can achieve full employment of resources without a high level of international exchange, unless they profoundly reorganize their economic structures—and economic reorganization which strives for a larger degree of national self-sufficiency can only result in a lowering of living standards. Competitive exchange depreciation, increasing protection, and abnormal credit expansion, for example, are policies that offer little promise of lasting high employment because they tend to impede a large movement of international trade. A satisfactory volume of international commerce, however, cannot be secured unless reasonably full employment can be attained, at least in the major industrial countries. Unemployment leads invariably to narrowly nationalistic economic policies, which tend to destroy international trade and to lower living standards throughout the world and fail, in the long run, even to improve employment.

Our international monetary system must therefore be a compromise. It must make room for national policies that aim at full production and employment, and that at the same time guarantee multilateral international clearing with reasonably stable exchange rates. The stabilization funds of the 1930's and the Tripartite Agreement of 1936 suggest the nature of such a compromise and point to the very heart of the plans which appear destined to shape international monetary cooperation in the postwar period.

A workable compromise must embody the following principles.<sup>18</sup>

(1) Each member country must possess large enough reserves of international money, i.e., gold, or the wherewithal to acquire any desired foreign currency, so that it can meet seasonal or other short-lived disequilibria in the balance of payments merely by drawing on these reserves, without being compelled to take action of a more disrupting nature, such as deflation, exchange depreciation, or the direct restriction of imports. Even where more fundamental adjustment is necessary, such reserves may be used to moderate the impact of corrective forces upon the domestic economy.

(2) Reserves of international money should not be used to pro-

<sup>18</sup> See George N. Halm, *International Monetary Cooperation*, Chapel Hill, 1945, Ch. IV. The reader will recognize my indebtedness to Professor Halm for much of the material in the present section.

## 716 International Trade and Commercial Policy

long a basically unbalanced international position. Pressure should be exerted on any country whose balance of payments persistently departs from equilibrium, in either direction, to induce it to pursue policies requisite to an orderly return to equilibrium.

(3) When it becomes recognized that a country's balance-of-payments troubles are not of a temporary nature but are caused by a fundamentally unbalanced international position and that basic adjustments must be made, the measures adopted for bringing a return to equilibrium should be those that promise to be least disturbing to the domestic economy. This means that changes in the par value of member currencies should be permitted if they are essential to the correction of fundamental disequilibria. Although *any* international adjustments are disturbing to the internal economy, the reduction of the par value of a country's currency will prove less disturbing, and will meet much less internal resistance, than deflation.

(4) Changes in the par value of member currencies must not, however, be by unilateral action. They should be made only by collective action and in an orderly way, so that competitive exchange depreciation is avoided. But substantial adjustments of exchange rates are to be avoided if possible, especially because of their deleterious effects upon international trade and international investment. The main desideratum of an international monetary system is, therefore, the integration of the credit policies of member nations so that necessary changes in the par value of member currencies will be infrequent. One of the greatest assets of an international monetary authority "would be its ability to keep the monetary authorities of the member countries in constant contact with one another, and, thereby, to make, more or less automatically, all member countries conscious of their inescapable interdependence. Thinking in terms of world economy, the different national authorities could no longer ignore the effects which their policies would have on member countries and, indirectly, upon their own economy."<sup>17</sup>

These four principles form the foundation for the proposed International Monetary Fund, for which articles of agreement were

<sup>17</sup> Reprinted from *International Monetary Cooperation* by George N. Halm, p. 41, by permission of The University of North Carolina Press. Copyright 1945 by the University of North Carolina Press.

signed by the delegates of the United and Associated Nations in a formal conference at Bretton Woods, N.H., in July, 1944. The final section of this chapter is devoted to a description and an analysis of the International Monetary Fund, which is a companion institution of the International Bank for Reconstruction and Development that was described in the last chapter.

**THE INTERNATIONAL MONETARY FUND<sup>18</sup>**

The outstanding feature of the Bretton Woods monetary proposals is the establishment of an international institution that is to deal with international monetary developments and balance-of-payments problems and is to be continuously on the job. This institution is the International Monetary Fund. While the Agreement permits individual nations a large degree of independence in matters of domestic credit, price, and employment policies, the Fund is to work for international collaboration and consultation in matters of international monetary relationships.

The purposes of the International Monetary Fund are, briefly:

- (1) to provide the machinery for international consultation and collaboration;
- (2) to fix the postwar structure of exchange rates, after consultation with each member country;
- (3) to promote exchange stability and to avoid competitive exchange depreciation;
- (4) to assist in the removal of foreign exchange restrictions that hamper world trade;
- (5) to aid member countries to achieve balanced trade without resort to deflationary policies; and

<sup>18</sup> *The Articles of Agreement of the International Monetary Fund* which were signed by the delegates of forty-four nations at Bretton Woods, N.H., on July 22, 1944, were the fructification of discussions growing out of the White (United States) and Keynes (Great Britain) Plans, both made public on April 7, 1943, and the Canadian Plan of June 9, 1943. The discussions growing out of these pioneer plans were brought to a preliminary conclusion by the publication on April 21, 1944, of a *Joint Statement by Experts on the Establishment of an International Monetary Fund*. This *Joint Statement* was a compromise of the earlier proposals and contained the basic principles upon which the monetary experts of the United Nations had agreed. The Bretton Woods Agreement entered into force in December, 1945, by which time it had been ratified by governments having more than 65 per cent of the total quotas.



## 718 International Trade and Commercial Policy

- (6) to provide machinery for the maintenance of orderly exchange arrangements among member countries and for the orderly adjustment of exchange rates when necessary for the correction of fundamental disequilibria.

### A RESERVE OF INTERNATIONAL CURRENCY

One of the chief contributions of the International Monetary Fund to exchange stability will be its ability to sell to any member country that may be facing a temporary deficit in its balance of payments the currency of any other member at a fixed rate. The Fund will thus augment the foreign exchange and gold reserves of its members. The resources of the Fund come from subscriptions by member countries, and will total 8.8 billion dollars. The subscription of each member is equal to an agreed quota which "gives due weight to important relevant factors, e.g., a country's holdings of gold and free foreign exchange, the magnitude and fluctuations of its balance of international payments, its national income, etc." Each member must contribute in gold 25 per cent of its quota or 10 per cent of its net official holdings of gold and United States dollars, whichever is smaller. The balance of its quota is subscribed in its own currency, in the form of a deposit in its central bank to the credit of the Fund.<sup>19</sup> The resources of the Fund thus consist of gold and the currencies of members.

Whenever a member country experiences a temporary inadequacy of another member's currency on her foreign exchange market, she may buy that member's currency from the Fund and pay for it in her own national currency. Thus, if the Bank of England needs dollars, it will be permitted to draw against the Fund's account with the Federal Reserve Bank of New York; the Fund's dollar account will decline and its sterling account with the Bank of England will go up. Since a country's total purchases from the Fund may, over a period of years, amount to its quota plus its gold contribution, the effective foreign exchange reserves of each member are greatly enlarged. A country whose gold contribution to the Fund equals

<sup>19</sup> The contribution of local currency may be in the form of non-interest-bearing obligations rather than deposits in the central bank. This alternative was designed (1) to prevent a serious decline in the reserve ratios of central banks and (2) to avoid having to float open-market loans when interest rates are high.

25 per cent of its quota may purchase from the Fund a maximum of five times the amount of its gold contribution. Although many countries have substantial international monetary reserves, many other countries, e.g., China, Czechoslovakia, Greece, and Poland, have quite inadequate reserves. By placing reserves of international money at the disposal of the member countries, the Fund operates to correct, to some extent, the present maldistribution of gold.

It should be emphasized that the Fund is not intended to supply virtually all the foreign exchange that any country will use. Foreign exchange dealings will take place in the ordinary, private channels precisely as they would were the Fund not in existence. The overwhelming proportion of international payments will be cleared without the help of the Fund. The resources of the Fund are intended merely to supplement the ordinary foreign exchange resources of the members; they are a second line of defense in meeting temporary balance-of-payments difficulties. Transactions through the Fund should be no more frequent during settled times than gold movements under the gold standard.

*The Role of Gold.* Gold plays an important role in the plan, yet the plan is not a return to the old gold standard. The currency of each member is defined in terms of gold, but, unlike the gold standard, the parity can be adjusted by mutual agreement in order to correct disequilibrium without forcing deflationary policies upon countries. Besides the gold originally acquired by the Fund from the subscriptions of members, the Fund may acquire additional gold from the sale of foreign exchange to members and from the repayment by members of loans made to them by the Fund. The Fund has the power to make a uniform change all around in the par value of all member currencies, provided that every member country having 10 per cent or more of the aggregate quotas approves. Such an all-round change in the price of gold will not affect exchange rates, but it will profoundly affect gold production in the world.

*Limitations on the Use of the Fund's Resources.* If many members desire to purchase the currencies of a few, a situation could arise in which the Fund's holdings of the desired currencies and gold are exhausted and the Fund's resources become frozen, consisting only of unsalable currencies. A Fund with unsalable currencies would cease to fulfill its reserves functions.

## 720 International Trade and Commercial Policy

Certain safeguards are provided, however, against the occurrence of such a situation. First, the purchasing rights of members are limited. (1) The payments for which the member needs the currency must be consistent with the provisions of the Agreement. (2) The Fund can give notice that its holdings of the desired currency have become scarce and that the currency demanded is consequently rationed. (3) The proposed purchase must not cause the Fund's holdings of the purchasing member's currency to increase by more than 25 per cent of its quota during the twelve-months' period ending on the date of purchase, nor to exceed 200 per cent of its quota. (4) The Fund must not have previously declared that the member desiring to purchase is ineligible to use the Fund's resources because of violation of provisions of the Agreement by the member or use by the member of the Fund's resources in a manner contrary to the purposes of the Fund. Furthermore, when the gold and foreign exchange holdings of a member exceed its quota in the Fund, such country in buying foreign exchange from the Fund is required to use its own resources of gold and foreign exchange to an extent equal to its use of the Fund's resources.

Second, the privilege of purchasing from the Fund involves service and interest charges to the purchaser. Every member that buys from the Fund has to pay a uniform service charge in gold equal to three-quarters of one per cent of the face of the loan. In addition, each member has to pay interest charges on the average daily balance of its currency held by the Fund in excess of its quota. These interest charges increase each year according to the duration and amount of such excess. When the charges reach five per cent, the Fund may impose whatever surcharges it deems appropriate.

Third, the Agreement contains provisions designed to ensure a constant replacement of the Fund's resources of local currency with gold. (1) If a country wishes to purchase foreign exchange with its own gold holdings, it is expected to do so through the Fund when it can do so with equal advantage. (2) A member may repurchase from the Fund with gold any part of the Fund's holdings of its currency in excess of its quota. (3) At the end of each financial year a member *must* repurchase from the Fund with gold or convertible currencies a part of the Fund's holding of its currency equal in value to one-half of any increase in the Fund's holding of its cur-

rency that has occurred during the year, plus one-half of any increase, or minus one-half of any decrease, that has occurred during the year in the member's monetary reserves. But the repurchase is not to be carried to a point at which the member's reserves would be below its quota or the Fund's holdings of its currency less than the original 75 per cent of the quota.

*Scarce Currencies.* The International Monetary Fund cannot go on indefinitely selling local currencies that are in persistent demand, because its holdings of any particular currency are limited. The Agreement contains provisions granting the Fund specific powers for dealing with scarce currencies, however, in addition to those that limit the buying privileges of members. (1) The Fund may require the member whose currency is scarce to sell its currency to the Fund for gold. (2) It may propose to the member whose currency is scarce that it lend its currency to the Fund. (3) It may formally declare such currency scarce and ration the existing supply among member countries. (4) It may authorize any member, after consultation with the Fund, to impose limitations on the freedom of exchange operations in the scarce currency. The amount of any local currency at the disposal of the Fund can always be increased by the amount of the Fund's gold holdings. But the prospect that its currency will be rationed may be so disturbing to any country whose persistently favorable balance of trade has caused the disequilibrium, and to powerful pressure groups therein, that the country whose currency is scarce may prefer to lend to the Fund rather than have its currency rationed.

*Security Behind Loans to Members.* Upon becoming a member, each country deposits with the Fund gold amounting to 25 per cent of its quota (or 10 per cent of its reserves of gold and foreign exchange) and local currency to make up the remainder of its quota. When a country borrows (buys) foreign exchange from the Fund, it must deposit to the credit of the Fund additional local currency equal to the amount of the foreign exchange it desires to borrow. Thus, every borrower will have turned over to the Fund an amount equal to its original quota, plus a dollar for every dollar borrowed. When a borrower's full line of credit is exhausted, the collateral held by the Fund as security for the loan will equal nearly twice the amount of the loan. The margin of collateral is even

## 722 International Trade and Commercial Policy

larger when the outstanding loans fall short of the full line of credit.<sup>20</sup> It is further provided that the gold value of the Fund's assets must be maintained. If a country's currency has depreciated, that country must pay to the Fund, within a reasonable time, an amount of its own currency equal to the reduction in the gold value of its currency held by the Fund.

### THE ADJUSTMENT OF FUNDAMENTAL DISEQUILIBRIA

The resources of the Fund are intended to help bridge only temporary disequilibria, i.e., balance-of-payments deficits which will normally disappear within a short time. By drawing upon the Fund's resources, a country may minimize the domestic disturbances caused by international disequilibrium. Where the disequilibrium is temporary, a borrowing nation should be able shortly to repay its loans to the Fund and thus maintain the liquidity of the latter's resources.

But persistent deviations from international equilibrium must be avoided. If they are not, resort must be had to the rationing of scarce currencies, or continual changes must be made in the par values of member currencies. Either course operates to defeat the purposes of the Fund. The rationing of currencies tends to restrict international trade, while frequent changes in currency parities are themselves exchange instability. If the Fund is to prevent the accumulation of trade restrictions, maintain a maximum flow of international trade, and preserve exchange stability, it must have at its disposal means for correcting international disequilibria of a fundamental nature. These means should operate upon both the deficit and the surplus countries; for a deficit in one country is a surplus in another. The Agreement does not overlook the need for dealing with deep-seated disequilibria.

*Deficit Countries.* The limitation upon the annual buying rights of members compels members with a balance-of-payments deficit to take appropriate measures for reestablishing equilibrium at an early date. If members could exercise these buying rights in un-

<sup>20</sup> A country which has contributed 25 per cent of its quota in gold can borrow from the Fund up to 125 per cent of its quota. But to do so, the country must put up additional currency in the amount of 125 per cent of its quota. Against loans totaling 125 per cent of a country's quota, the Fund will thus hold collateral of gold and local currency equivalent to 225 per cent of the quota.

restricted amounts whenever they wanted to, such steps might be unduly postponed. The levy of interest charges, graduated according to the duration and amount of borrowing, upon members borrowing from the Fund is also intended to act as a deterrent to continual borrowing and to encourage members to take the necessary measures for the restoration of equilibrium. It is to be doubted, however, that the payment of even substantial interest charges will discourage a country facing serious balance-of-payments difficulties from using its full line of credit with the Fund.

The Fund's resources are not to be used to meet a large or sustained outflow of capital. When such a capital outflow occurs, members are permitted to deal with the situation by the institution of exchange control. If equilibrium cannot otherwise be established, the par value of the member's currency may be reduced, and the Fund shall concur in the proposed change if it is satisfied that the change is necessary to correct a fundamental disequilibrium.<sup>21</sup> Where the Fund is satisfied that a change in the par value of a member's currency is necessary to correct a fundamental disequilibrium, it shall not object to the proposed change because of the domestic or political policies of the member proposing the change. The Fund has the power to make reports to any member country regarding economic conditions and developments within that country which tend to produce a serious disequilibrium in its international accounts. The absence of the power to deny rate changes on the ground of incompatible domestic policies suggests, however, that the Fund will rarely interfere with domestic wage and credit policies and that the report to the deficit country will probably not contain deflationary recommendations. The extent to which currency devaluations and exchange controls are avoided will therefore depend upon the willingness of members to bring their domestic policies into a harmonious whole.

<sup>21</sup> A change in the par value of a member's currency may be made only on the proposal of the member and only after consultation with the Fund. If the proposed change does not exceed 10 per cent of the initial par value, the Fund shall raise no objection. If the proposed change does not exceed a further 10 per cent of the initial par value, the Fund may either concur or object; but it shall declare its attitude within 72 hours if the member so requests. Where the proposed change exceeds 20 per cent of the initial par value, the Fund may either concur or object; but it shall be entitled to a longer period in which to declare its attitude. (Agreement, IV-5-c.)

## 724 International Trade and Commercial Policy

*Surplus Countries.* The restoration of equilibrium has to be approached from the side of the creditor country as well as from that of the debtor. We have already seen how, when members desire to purchase an amount of a given local currency in excess of the Fund's stock of that currency, the Fund is empowered to purchase (for gold), to borrow, or to ration the scarce currency. Borrowing and rationing are means for creating a temporary and artificial balance. But they do not restore the fundamental equilibrium position in which the basic causes of the scarcity of the surplus country's currency are eliminated. The Agreement provides, however, that the Fund may, by a two-thirds majority vote, publish a report to any member regarding any monetary or economic conditions and developments in such country that directly tend to produce a serious international disequilibrium. The Fund may, furthermore, communicate at any time information to any member regarding such matters. Recommendations to surplus countries could include: an increase in foreign investments, domestic credit expansion, the upward adjustment of money wages—if out of line with efficiency rates, the expansion of imports by the reduction or removal of trade barriers, and the appreciation of the foreign exchange value of the member's currency. Many of these policies would meet strong political opposition. Currency appreciation, for example, would be strongly opposed in a country with large gold holdings. Yet the case for the appreciation of a surplus country's currency may be just as strong as the case for the depreciation of a deficit country's currency. And appreciation is likely to need the support of the Fund much more than depreciation.<sup>22</sup>

*Automatic Adjustment Forces.* Currency transfers in the Fund effect an equilibrating process which goes on automatically, unless it is counteracted by the domestic monetary policies of members. This process resembles the gold-flow-price mechanism. Currency transfers in the Fund affect bank reserves, the monetary circulation, and prices in precisely the same manner as does the movement of gold under the gold standard. Gold movements are not necessary, but their function is preserved.<sup>23</sup>

<sup>22</sup> See George N. Halm, *International Monetary Cooperation*, pp. 70-73.

<sup>23</sup> See John H. Williams, "Currency Stabilization: The Keynes and White Plans," *Foreign Affairs*, Vol. XXI, July, 1943, pp. 649-650.

When a deficit country buys foreign exchange from the Fund, the purchaser is the central bank of the country. The central bank then sells the acquired foreign exchange to member banks, which, in turn, sell it to their customers. The net effect of this process is to reduce both the demand deposits of member banks and their reserve deposits with the central bank. But, since member banks are obliged to hold only fractional reserves against their deposits, their reserve position is weakened. Unless member banks hold surplus reserves, credits must be contracted, with deflationary effects on the national income, prices, employment, and imports. Deflation may, of course, be obviated if the loss of member bank reserves is made up by an expansion of central bank credit.

Opposite effects result in the surplus country. Foreign exchange obtained from net exports is sold to the central bank by member banks. This improves the reserve position of member banks and tends to increase incomes, employment, prices, and imports and to discourage exports. The potential credit expansion may, however, fail to materialize because of a restrictive central bank policy or the unwillingness of business to expand.

#### AN INSTITUTION FOR INTERNATIONAL CONSULTATION

The functions of the Fund are not limited to helping members over temporary balance-of-payments difficulties and to making appropriate, orderly changes in exchange rates. The Fund is also to be concerned with the more fundamental tasks of international co-operation and the promotion of the balanced development of world trade and world production. It is to this end that the Fund is obligated to make a report to any member country that is using the resources of the Fund in a manner contrary to its purposes, setting forth the causes of general world unbalance and, in particular, of the lack of balance between that country and the rest of the world. The report may concern any monetary or economic conditions or developments in that member country which directly contribute to a serious international disequilibrium.

In order that it may be in a position to furnish intelligent and informed leadership, the Fund is obligated to engage in continuous research on international conditions and developments. Each member is required to furnish the Fund information deemed necessary



## 726 International Trade and Commercial Policy

to promote the functions and purposes of the Fund. The information that may be requested involves data on: the international balance of payments of each country, official and private holdings, at home and abroad, of gold and foreign exchange, the international investment position of each country, commodity-price indices, national incomes, comprehensive statements of exchange controls, amounts awaiting clearance in commercial and financial transactions where official clearing arrangements exist and the length of time during which such arrangements have been outstanding. Armed with such powers for obtaining adequate information from the various member countries, and entrusted with the duty of analyzing and reporting to the world on this information, the Fund will be in a position to make a significant contribution to an orderly world development.

### TRANSITION PERIOD

The Fund has been assigned important duties for the transition period immediately following the war. Two problems in particular lie in the way of restoring international equilibrium and a free flow of international trade—namely, the fixing of currency parities and the removal of exchange controls. The danger of inflation resulting from the shortage of all kinds of goods and from the threatened spending of monetary hoards will make it imperative that price ceilings, rationing, priorities, and exchange controls be maintained well into the postwar period. The removal of many controls in the United States was soon followed by sharp advances in prices. Under such conditions, it will be virtually impossible to ascertain what the equilibrium rates of exchange are. The appropriate rates can be found only by experimentation and experience. If every country were left free to make this decision by itself, without international consultation, the process of adjustment would be chaotic and disturbing. No country could be trusted to set an exchange rate that would not give it an undue competitive advantage in world markets.

The Agreement leaves the initial determination of par values to members. But it recognizes that these initial rates may not be satisfactory, and that they may consequently require very substantial adjustments. If either the member or the Fund considers the initial par value of that member's currency to be unsatisfactory, the Fund

and the member shall, within a period determined by the Fund in the light of all relevant circumstances, agree upon a suitable par value for that currency. The proper exchange rate in every case is thus to be found by a process of trial and error. The necessary adjustments in rates, however, are to take place under the careful scrutiny of the Fund, not by unilateral action.

The elimination of foreign exchange restrictions which hamper the growth of world trade is a stated objective of the Fund. During the war, exchange control was universal. Because most belligerents and many neutrals will be in dire need of imports of foodstuffs, equipment, and raw materials in the immediate postwar period and will, at the same time, be unable to produce sufficient exports wherewith to pay for these imports, the premature removal of these exchange controls could be disastrous. For this reason, the Agreement provides for the continuation of exchange controls during the postwar transition period. But it also provides that exchange controls shall be removed by progressive stages as soon as the underlying facts warrant. If exchange control is still in force in any country after three years, the Fund shall report on any restrictions still in force. Any country in which the restrictions continue in force after five years must consult with the Fund in respect to a program leading to their removal. If the Fund finds that the member persists in maintaining restrictions which are inconsistent with the purposes of the Fund, it may declare the member ineligible to use the resources of the Fund.

#### CONCLUSION

The International Monetary Fund represents a beginning in international economic cooperation for the postwar world. But the plan itself is an experiment, and experience may demonstrate that it needs modification in certain respects. In prospect, it can be said that the success of the plan in fostering a maximum flow of international trade and improving world living standards—by assuring unrestricted multilateral clearings and a reasonable degree of exchange stability—will rest upon a considerable harmony of national policies. Widely divergent national price trends must inevitably lead to frequent changes in exchange rates or to exchange control. Resort to either will interfere with the international flow of goods

## **728 International Trade and Commercial Policy**

and capital. Although the plan undertakes to grant to individual members wide latitude in domestic price and credit policies, national policies must be tempered by a consideration of their international repercussions.

The establishment of the International Monetary Fund does not clear all obstacles from the path of international trade. The mass of tariffs, import quotas, and other trade-control measures must be reduced to reasonable proportions, and relief and reconstruction aid must be advanced to war-torn areas before the flow of international commerce can be expected to attain its full development. The Fund cannot, and is not designed to, deal with innumerable transitional problems. Other institutions have been established to deal with these problems. The United Nations Relief and Rehabilitation Administration was set up to deal with problems of postwar relief (its functions were taken over by the United Nations in 1947) while the International Bank for Reconstruction and Development has the power to make loans for the rebuilding of devastated regions. Preliminary conferences have already been held, and others are under way, to consider such important transitional problems as shipping, the control of air routes, international cartels, commodity agreements, the transplanting of populations, the control of German industry, and many other problems. The United Nations Charter, signed at San Francisco on June 26, 1945, provides for the establishment of an Economic and Social Council which shall act as a permanent body for international cooperation in economic and social matters. This Council may make or initiate studies and reports with respect to international economic, social, educational, health, and related matters, and may make recommendations with respect to any such matters to the General Assembly, the United Nations, and specialized agencies concerned.

The prerequisites of postwar stability are many. They include, first of all, political stability. There can be no economic stability in a politically unstable world. Internal financial stability is also essential. To this end, inflation must be checked. This calls for the maintenance of price and rationing controls during the transition period, the funding of floating debts, the unpegging of interest rates, the severance of commercial banks from deficit financing. War debts

and reparations must be settled in such a reasonable way that they will not be a cause of future economic and political disturbance. Some means must also be found for the gradual liquidation of the vast sterling balances blocked in England, estimated at from twelve to fifteen billion dollars, and for restoring England's economic position, which has been seriously impaired by the enforced liquidation during the war of most of her foreign investments. Tariffs must be reduced and trade restrictions removed. Finally, if tariffs are to be stabilized at a reasonably low level, severe deflation and unemployment must be avoided. Political stability, internal and international financial stability, the settlement of war debts and reparations, reconstruction, tariff reform, the removal of trade barriers, and general economic stability are all parts of the postwar economic problem. Failure to solve any one will react upon the others and will jeopardize future international balance.

#### APPENDIX TO CHAPTER XXVI THE GOLD EXCHANGE STANDARD

The gold exchange standard is a variation of the gold standard. It was adopted by India in the 1890's and by the Philippine Islands in 1903, and was employed by various other nations in the inter-war period. This system enables a country to keep the value of its currency stable in relation to gold currencies without the expense of having to maintain a gold reserve. The local currency of the gold exchange standard country may consist of either silver or paper; no gold coins circulate. A government agency, or the central bank, keeps a reserve in the form of bank balances or short-term investments in a money center in some gold standard country, and a ratio is fixed between the local currency and that of the gold standard country. The government, or central bank, offers to sell in unlimited amounts drafts drawn against its balance in the gold center at a price slightly above this par, and, through an agency in the gold center, it offers to sell drafts drawn in its own currency in unlimited amounts for the gold currency at a price slightly above par. The official selling rate in each center is set approximately at the specie exporting point. Thus, fluctuations in the exchange rate between the two countries are confined within the narrow limits of these buying

## **730 International Trade and Commercial Policy**

and selling points, just as they are restricted within the limits of the specie points under the gold standard. The advantage of the gold exchange standard over the gold standard is that the former relieves the gold exchange standard country of the expense of maintaining a gold reserve and a circulation of gold coins. The gold exchange standard country must, to be sure, maintain ample foreign balances. But these balances can be invested to yield interest, whereas domestic gold reserves are unproductive.

The adjustment of international disequilibria under the gold exchange standard resembles adjustment under the gold standard, but it differs from the gold standard adjustment in some respects. Where the government impounds the local funds that it receives from the sale of drafts on the gold center, a balance-of-payments deficit leads to an automatic currency contraction in the gold exchange standard country, and a balance-of-payments surplus leads to a currency expansion. The contraction, or expansion, of the currency tends to restore equilibrium by forcing changes in prices and incomes.

When the disequilibrium involves the gold center as well as the gold exchange standard country, the pressure upon the depositary's credit system is less than it is under the gold standard. If the gold exchange standard country's reserve in the gold center is impounded in inactive balances, the credit contraction, or expansion, in the latter that is caused by the movement of funds into, or out of, these inactive balances is limited to the amount by which these balances are augmented, or diminished. For the depositary country does not lose, or gain, gold, and consequently experiences no alteration in its banking reserves. If, on the other hand, the gold exchange standard country keeps its foreign reserves fully invested, the operations of the reserve do not affect the monetary circulation in the gold center; money paid into the reserve fund is immediately released to the money market, and money paid out of the reserve fund is merely shifted from the money market into commercial and financial channels. When the gold exchange standard is operated through the country's central bank, the effects of sales or purchases of foreign drafts by the central bank upon the gold exchange standard country's monetary circulation depend upon central bank policy. An outflow of funds can be completely neutralized by an expansion of cen-

tral bank credit, or an inflow of funds can be offset by a contraction of central bank credit.<sup>24</sup>

The gold exchange standard effects an economy in the world's use of gold when the banking laws authorize the central bank in the gold exchange standard country to count foreign balances as legal reserves. The gold reserve of the gold center, or at least a portion of it, can then serve as the banking reserve of the gold exchange standard country as well as the gold country. Both countries can build their credit superstructure upon the same gold reserve. The gold exchange standard was the keystone of the plan approved by the delegates of the European nations at the Genoa Conference in 1922 for economizing gold in the face of an anticipated shortage of the metal. Because it allows two nations to erect an edifice of credit on the same gold base, however, the gold exchange standard carries definite inflationary possibilities. But the central bank of the gold center can successfully parry the threat of inflation by maintaining 100 per cent gold reserves against the deposits of foreign banks. Such a policy would debar any credit expansion in the gold country on gold deposited there by foreign banks. This might be a judicious policy on the part of the central bank in view of the highly volatile nature of such deposits.

The encouragement which the gold exchange standard gives to the accumulation of foreign-owned short-term funds in the financial centers that act as depositaries is a serious objection to the widespread use of the system. The existence of these foreign obligations exposes the monetary and banking systems of the depositary countries to the hazard of sudden and unpredictable gold drains. Any loss of confidence in the security of these foreign-owned reserves will precipitate their withdrawal. It was just such a withdrawal of foreign-owned short-term funds that forced England to abandon the gold standard in 1931, and only the very large gold reserves possessed by the United States enabled this country to withstand successfully similar pressure in 1932. Only the maintenance of 100 per cent reserves against foreign-owned short-term assets can prevent large withdrawals from disturbing the money market of the depositary—and such large reserves are rarely feasible. The at-

<sup>24</sup> The central bank can, of course, also neutralize the effects of gold flows under the gold standard by an appropriate credit policy.

## 732 International Trade and Commercial Policy

traction of foreign-owned short-term funds to international money centers does not, of course, arise entirely from the gold exchange standard. The search for refuge from currency depreciation and speculation in foreign exchange also cause large international movements of such funds.

Another serious disadvantage of the gold exchange standard is that it places the monetary reserves of gold exchange standard countries at the mercy of the political and economic currents in, and policies of, a foreign country, or countries. The system may work well so long as conditions in the countries in which reserves are held are normal. But events may arise in the depositaries that cause serious losses and inconvenience to the depositors. If the depositary becomes involved in war, or institutes moratoria or control of the foreign exchanges, foreign depositors will find their reserves frozen. If the currency of the depositary becomes depreciated, foreign central banks will suffer losses which may impair their very solvency. This risk is well illustrated by the heavy losses experienced by the Bank of France on its London balances when Great Britain suspended gold payments in 1931. Experiences since 1929 have increased the reluctance of central banks to carry reserves in the form of large balances in foreign banks.

The experiences of the inter-war period show that the adoption of the gold exchange standard by many countries is conducive to the formation of blocs. This development may be incompatible with multilateral trade because it tends to encourage trade among members of a particular bloc to the exclusion of trade between members of the bloc and outside nations.<sup>25</sup>

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<sup>25</sup> See George N. Halm, *op. cit.*, p. 157, and J. B. Condliffe, *Reconstruction of World Trade*, pp. 317-318. The gold exchange standard is discussed more fully in: John Maynard Keynes, *Indian Currency and Finance*, London, 1913; George F. Luthringer, *The Gold Exchange Standard in The Philippines*, Princeton, 1934; Edwin Walter Kemmerer, *Gold and The Gold Standard*, Princeton, 1944; League of Nations, *Selected Documents Submitted to the Gold Delegation*, 1930, "Reform of the Gold Exchange Standard," by Dr. Felix Mlynarski.

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## *The Future of International Trade*

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Great masses of the world's population lived in dire poverty even before the recent war. The ravages of war have still further impaired the fortunes of the impoverished masses and have plunged additional millions into poverty. Even in countries which enjoy relatively high standards of living, which have been little injured by the war, the economic well-being of the people falls far short of human desires and potentialities. Too many are still ill fed, poorly clothed, inadequately housed, and lack proper medical and dental care, opportunities for vocational and cultural training, and leisure for self-improvement and enjoyment. There is only one road to the improvement of the material welfare of mankind—production, more production, and still more production. Man must strive continuously to wrest from the limited productive resources at his disposal a larger and larger social product.

The means to this goal are familiar enough—a constantly improving technology, increased capital equipment, free access to the world's raw materials, a more efficient organization of the productive agents, and a social organization which assure continuous, full employment. Not the least important of man's allies in his struggle to attain an ever expanding industrial output is a structure of international relationships which will permit unshackled, multi-lateral world trade and geographical specialization based upon comparative advantage. For, as has been repeatedly pointed out in the pages of this book, maximum production cannot be achieved without specialization in production and trade, not only on a community and national basis, but on an international basis as well. Trade is one of the main hopes of people with limited resources for raising their

## 736 International Trade and Commercial Policy

living standards. But trade also benefits peoples more richly endowed.

What, then, are the prospects that geographical specialization and a thriving world trade will play a major role in raising world living standards in the years and decades ahead?

### ARE THE FOUNDATIONS OF INTERNATIONAL TRADE CRUMBLING?

There are prophets who warn us that the very basis of international trade and geographical specialization is being slowly, yet inexorably, undermined, that the benefits from trade are diminishing appreciably, that international trade must in the future suffer a substantial decline. The decline in international trade which they foresee is something apart from any decline that may result from restrictive measures emanating from nationalistic sentiment. It is the result, rather, of the operation of basic technological, economic, and social forces. Foremost among these forces is the diffusion of modern productive techniques among the industrially backward regions of the globe. As the outlying areas of the world become industrialized, it is argued, the need for, and the advantages of, specialization decline, and the volume of international trade must become much less than before. ". . . the machine has long since ironed out regional productive differentiation; except in the case of labor differentials, it is cheaper to produce manufactured goods at home than it is to import them."<sup>1</sup> The late Lord Keynes also gave expression to the same view: "Experience accumulates to prove that most modern processes of mass production can be performed in most countries and climates with almost equal efficiency."<sup>2</sup>

Another reason why specialization may be expected to become less advantageous in the future is that agriculture in the new countries is coming up against diminishing returns. As a consequence, these countries will find their comparative advantage in producing foodstuffs and raw materials disappearing if they push their produc-

<sup>1</sup> John Chamberlain in the *New Republic*, June 29, 1938. Mr. Chamberlain credits this proposition to Professor Charles A. Beard, *The Open Door at Home*, New York, 1934.

<sup>2</sup> J. M. Keynes, "National Self-Sufficiency," *Yale Review*, Vol. XXII (1932-1933), p. 760.

tion of these commodities much farther.<sup>3</sup> Furthermore, electricity and oil are releasing industry from dependence on coal. The advantage of locating industry close to the coal fields is thus weakened, while the advantages of locating near the market, or near sources of other materials, are strengthened. This points away from specialization, and toward the diffusion of industry.<sup>4</sup> Finally, the slowing-up of population growth indicates that the demand for the simpler food-stuffs will not increase as rapidly as production. Agricultural countries will therefore find it more and more difficult to export, and, in order to maintain and improve living standards, will be compelled to industrialize. Since lagging exports will make it more difficult for these countries to service their foreign debts, they will be less inclined to borrow, and lending countries will be less willing to lend to them.<sup>5</sup>

These arguments are impressive. Yet it should be kept in mind, as Professor Ellsworth points out,<sup>6</sup> that the benefits of international trade rest upon national cost-differences. The spread of modern techniques, the partial release of industry from dependence on coal, the slowing-up of population growth, and the inexorable operation of diminishing returns in agriculture in the new countries will reduce the need for, and the advantages of, international specialization only insofar as they tend to equalize costs everywhere. If, despite these forces, cost-differences between nations remain, the basis for international specialization and a profitable world trade remains. The benefits of trade disappear only if national cost-differences disappear, or are sharply narrowed.

The diffusion of technical knowledge and the spread of modern techniques may, it is true, eliminate national cost-differences. But they need not necessarily do so. It must be kept in mind that nations differ widely in climate, natural resources, human aptitudes

<sup>3</sup> D. H. Robertson, "The Future of International Trade," *Economic Journal*, Vol. XLVIII (1938), pp. 1-14.

<sup>4</sup> *Ibid.*

<sup>5</sup> Royal Institute of International Affairs, *The Problem of International Investment*, Ch. VII.

<sup>6</sup> *International Economics*, p. 514. Professor Ellsworth has made an admirable analysis of this proposition, *ibid.*, pp. 514-520. The current discussion is based in part upon Professor Ellsworth's analysis.

## 738 International Trade and Commercial Policy

and skills, levels of culture, social institutions, density of population, and capital equipment. Where the new techniques are suited to a fairly wide variety of conditions of factor supply and other relevant conditions governing the localization of industry, the diffusion of the techniques may bring a parallel diffusion of industry. Where this situation exists, the volume of international trade in the particular commodities involved will necessarily be reduced. The spread of the cotton textile industry to numerous new countries in recent decades has led many to conclude that this industry falls into such a category. The imposition of protective import duties on cotton textiles by most countries, however, makes it impossible to be sure that such a conclusion is warranted. The survival of the industry in new countries behind a protective tariff wall is no proof that the industry is producing as cheaply in its new habitat as it is in those countries where it has been long established.

The spread of advanced techniques to industrially young countries may, however, be perfectly compatible with a large volume of international trade. On the one hand, the new techniques may be better suited to the factor equipment and social conditions affecting the localization of industry in the young countries than to the underlying conditions in the country where the technique originated. Where this is true, there will be a shift in the localization of industry, but no necessary decline in the volume of international trade. The country which originated and developed the technique will no longer export the commodity in question; it will now import the commodity from the young country. On the other hand, even though the technical knowledge and techniques are exported, the basic economic and social conditions may still favor the localization of an industry in the country of its origin, and that country may retain the role of a major exporter of the commodity. This appears to be the case with the automobile, the office equipment, and the agricultural equipment industries in the United States, and the woolen and worsted industries in England. Finally, certain modern techniques may be so well suited to a particular country that it becomes unprofitable to develop other industries there, or becomes profitable to abandon some established industries. In the late nineteenth and early twentieth centuries, for instance, Germany found the chemical,

electrical equipment, and steel industries so profitable that she applied more and more resources to these industries, and fewer and fewer resources to agriculture and textiles. To an increasing degree, she became dependent upon imports for her supplies of textiles and foodstuffs. Likewise, other industrially young countries may discover, as they acquire technical skill, that they are so superior in one, or a small number of, lines of manufacture that it simply does not pay to venture into others, although the requisite technical knowledge may be readily available.

Those who argue that the spread of the machine technique to the outlying areas of the world must inevitably cause the volume of international trade to decline take an oversimplified view of international trade. This view regards trade as an exchange between classes of goods—manufactures for foodstuffs and raw materials. Actually, trade is an exchange of particular commodities, highly specialized and becoming more specialized day after day. The United States exports to Great Britain such highly manufactured goods as automobiles and office machinery. She exports to Germany (or did before the war) business, agricultural, and industrial machinery. But she also *imports* highly manufactured goods from both these countries: certain types of textile machines from the former; dyes, chemicals, and a variety of tools from the latter. Technical knowledge is not simple and homogeneous; it is divided into many branches. No nation has a monopoly of leadership in *all* branches. Each of the highly industrialized nations of today has superiority in some one or more fields of technology.

Furthermore, any nation which adopted all the most advanced techniques would soon discover that some of its industries were unable to compete with industries in foreign countries. For technology does not stand still; it is continually progressing. And no nation has a monopoly of progress and invention. In the past, one nation has assumed the leadership in a certain industry, or industries, while other nations have led in different industries. There is no reason to believe that this situation will change in the future. Only by concentration and national specialization can technical progress be maintained and the most up-to-date technique be utilized. Industrial specialization leads to more rapid technical progress and the most thorough utilization of modern technical methods. The techni-

## 740 International Trade and Commercial Policy

cal superiority of any country is likely to be confined to a limited number of branches of industrial activity.

As agricultural countries industrialize, the older industrial countries will experience new competition in some lines of production, both in the home market and in foreign markets. But the countries of advanced industrialism will find new markets opening up abroad for other kinds of products. These new demands will appear in the fields of the more highly technical goods, capital goods, and various consumers' goods. But, if the advanced countries expect to maintain their industrial leadership, they must keep forging ahead, adopt new techniques, and on occasion shift to new kinds of products. "Government, business and labour in the advanced countries will be wise to reject proposals for defending vested interests against the need for change and to adopt instead a policy of facilitating and encouraging adjustment."<sup>7</sup>

Certain effects of the machine technique tend to enlarge, not narrow, the scope of world trade. The machine lowers transportation costs and thus tends to widen the cost-differentials between regions; cost-differentials are the very basis of international trade. The machine is the foundation of large-scale industry, and the growth in the scale of industrial production has set such huge demands for all sorts of materials that only by concentrating on the best sources can these demands be met at reasonable cost, if they can be met at all. The advantages of large-scale production, furthermore, increase the production-cost differential between a large industry supplying an international market and a local home industry. "There will eventually be some large-scale industries in every country, but they will be *different* in different countries, all exchanging their products and all getting the economies of a large market."<sup>8</sup> Finally, the machine raises living standards. As industrialism becomes rooted in less developed regions, the peoples of these regions may import less of some consumers' goods; but the rise in their living standards will inevitably lead them to import greater quantities

<sup>7</sup> Eugene Staley, *World Economic Development: Effect on Advanced Industrial Countries*, International Labor office, p. 30.

<sup>8</sup> Eugene Staley, *World Economy in Transition*, Council on Foreign Relations, Inc., p. 83.

of capital goods and many specialized consumers' goods. Changes in national incomes are one of the most important factors affecting the volume of international trade.<sup>9</sup>

There are reasons for believing that the outlook for the agricultural countries may not be as discouraging as the slackening of world population growth and the operation of diminishing returns seem to forebode. In recent decades, the application of science to agriculture has brought phenomenal improvements in agricultural technology, improvements which rival in their effects those witnessed in manufacturing a century earlier. The mechanization of agricultural operations, improvements of the breeds of animals and plants, and the use of commercial fertilizers have combined to multiply many fold the output per worker on the farms. But the industrial revolution in agriculture has not redounded equally to the benefit of agriculture everywhere. The scientific achievements in agriculture have inured chiefly to the benefit of the large farms of the prairie, not to the fragmented farms of western Europe. Thus, the comparative advantage in agriculture possessed by the newer countries, which seemed to be vanishing under the inexorable pressure of diminishing returns, has been restored, and even strengthened, by technological progress. Improvements in transportation by land, sea, and air, and the refrigerator car and refrigerator ship, reinforce the advantages of agricultural specialization.

Prospects of adequate markets for an expanding agricultural output, furthermore, are not as bleak as the declining rate of population growth would at first glance seem to indicate. Studies on nutrition by the League of Nations in the inter-war period reveal that a large proportion of the world's population is still undernourished. Larger incomes will make it possible for millions of people throughout the world to meet more adequately the basic need for food. The sharply increased consumption of meat, dairy products, fruits, and vegetables by the people of the United States during the recent war clearly demonstrates how readily the markets for agricultural products will expand even in a country as well-fed as the United States, if only the people have sufficiently high incomes. How much vaster is the potential market for foodstuffs in the ill-fed areas of southern

<sup>9</sup> *Ibid.*, pp. 32-35, 82-83.



## 742 International Trade and Commercial Policy

and eastern Europe and Asia! And we are just beginning to appreciate the extensiveness of the market that science can open up for agricultural products as raw materials for industry.

A careful appraisal of basic economic and social trends, which some have interpreted as being extremely unfavorable to the future development of international trade, leads to the conclusion that on balance these basic conditions governing international trade remain highly favorable to a vigorous and profitable trade in the future. The large volume of goods that continued to move internationally—not only between agricultural and manufacturing countries, but also between manufacturing countries themselves—right up to the outbreak of war, despite the existence of tariffs and other impediments to trade, is concrete evidence of the considerable advantages realized by all countries from the exchange of goods with other countries. The persistent international flow of goods in the face of tariffs and other restraints on trade is strong evidence that the continuance of such restraints involves a heavy social loss, that the reduction of these barriers would result in a real gain.

The danger to international trade in the future does not lie in unfavorable basic economic and technological conditions. It lies rather in forces of a political nature, forces which are responsible for the imposition of artificial restraints upon trade. Trade restraints in recent decades have resulted largely from a single cause, fear—the fear of unemployment, and the fear of war. The trend of international trade in the years ahead will depend, in large degree, upon the extent to which the nations of the world succeed in dispelling these fears.

### INTERNATIONAL COOPERATION THE BASIS OF A SOUND WORLD ECONOMY

Wars inevitably disturb the course, and change the character, of international trade. The wider the area of war, the more profound are the changes that it causes. It was not possible to restore the prewar pattern of world trade after the first World War. Heavy material damages, disordered internal finances, the collapse of currencies, disturbed balances of payments, the loss of foreign assets by many countries, the development of new industries that replaced

former imports shut off by war, the stimulation of production in lines quite unsuitable for peacetime requirements, and the modification of international debtor-creditor relationships, all profoundly affected the course of economic history and produced a pattern of international trade sharply different from that of the prewar period. The recent global war involved hostilities on an even vaster scale. It brought about an unprecedented destruction of property and caused immense displacements of population. It has increased the productive capacity of many countries in South America, Africa, the Near East, Mexico, and India, while it has substantially reduced that of many European countries. It has caused substantial duplications of productive capacity, changed relative production costs in the different countries, forced exchange rates out of line with the internal values of national currencies, and radically altered debtor-creditor relationships. The effects of the second World War upon the world economy and international trade are consequently bound to be even more disturbing than those of the first World War.

The nations of the world are today faced with the necessity of developing a policy and a program for the revival and expansion of international trade. There seems to be little hope that the virtually unregulated system of international trade that served the world so well in the period before 1914 can be revived. Such a system was admirably adapted to a world made up of capitalistic nations whose economies were characterized by free enterprise. Outside of the United States, however, the area of free enterprise has been sharply narrowed. To be sure, the state-controlled economies of Germany, Italy, and Japan have been destroyed. But the Russian economy still remains under complete state control, and most of eastern Europe has been brought into the Russian economic orbit. Such traditional strongholds of free enterprise as Great Britain and France are turning more and more to the socialization of industry. France has already nationalized her railroads, her coal mines, and her largest banks, and plans to carry her program of nationalization still further. The British Labor government has inaugurated an elaborate program for nationalizing the Bank of England, coal mines, railroads and communications, and possibly shipping and some heavy industry. What kind of economy will emerge from the ruins in Ger-

## 744 International Trade and Commercial Policy

many, Italy, and Japan, it is too early to say. But it seems certain the state will exercise a much greater degree of control over economic affairs in these countries in the future, as well as in most of the countries that were occupied during the war, than it did prior to 1914. The struggles of those nations which have been the most faithful to the principles of free enterprise to wipe out the scourge of unemployment have forced the governments of even those nations to assume an unprecedented control over business activities, even on occasion to take a direct hand in matters affecting foreign trade.

Because of these developments, many are of the opinion that the trend toward direct government control over foreign trade is irresistible, that there is no alternative but to accept national controls of foreign trade, that the surest way of expanding international trade is to have foreign trade carried on directly by governments or their agencies.

The experience of the world with governmental control of foreign trade in the inter-war period offers little assurance that a prosperous, expanding, multilateral world trade based upon comparative advantage can be attained under such a system. National controls of foreign trade in this period were usually operated for the immediate national self-interest, with little regard for the damage which such controls often inflicted upon foreign economies. Those foreign trade controls that were adopted for the purpose of supplementing domestic controls designed to relieve unemployment or to bolster a deteriorating balance-of-payments position all too frequently caused serious injury to other nations. Under such controls, bilateral trade tended to supplant multilateral trade. Normal trade channels became blocked, and trade was diverted more and more away from the channels marked out by comparative advantage. Too often, furthermore, national control of foreign trade became an instrument employed by the strong to dominate the weak. Finally, national controls tended to choke trade at its very source, as business and industrial executives found that an increasing proportion of their time was consumed in grappling with a mass of red tape created and administered by a giant state bureaucracy. Foreign trade that is directed by the state is likely to be markedly different in character from foreign trade that is conducted by numerous individuals guided by commercial motives.

There is small prospect that governments will in the future dare to forego the exercise of national controls over their domestic economies or to expose their domestic markets to the repercussions of currency devaluations, exchange controls, import controls, and export subsidization by foreign countries, or even to the fluctuations of wholly unregulated international trade. People are no longer willing to suffer persistent depression and mass unemployment passively. Any government that fails to take every reasonable, and even heroic, measure to prevent and combat economic depression can expect short shrift at the hands of the masses. If unregulated foreign trade and free foreign exchanges threaten the success of anti-depression measures, or threaten to facilitate the transmission of depressions of foreign origin to the domestic economy, then foreign trade and the foreign exchanges will be brought under government control.

In view of this new responsibility which has been thrust upon governments, ". . . the alternative to rigid and potentially predatory national foreign-trade controls is not likely to be found in an effort, almost certainly abortive, to induce countries to remove such controls completely as a free act of international good will."<sup>10</sup> International cooperation is the one hope of restoring a multilateral world trade that will be relatively little restricted by national controls. Only through international cooperative agreements can the world hope to secure the removal of some of these controls and the elimination of the most objectionable features of those that remain. The work of supplanting and coordinating national foreign trade controls can be tremendously facilitated by the establishment of international institutions for encouraging and regulating world trade. Such institutions can maintain continuous contact with economic developments throughout the world, and can provide a permanent meeting ground for the discussion of world economic problems. Unless a high degree of international cooperation can be achieved, the volume of international trade and the benefits to be gained from geographical specialization will fall far short of what the world can reasonably expect.

<sup>10</sup> Reprinted by permission from *International Trade and Domestic Employment* by Calvin B. Hoover, p. 4, copyright, 1945, by the Committee for Economic Development and published by McGraw-Hill Book Company, Inc.

**TRANSITIONAL PROBLEMS**

The rebuilding of a sound world economy depends upon finding prompt and satisfactory solutions to many difficult transitional problems and upon erecting a solid foundation upon which a vigorous and expanding international trade can be developed along the lines of comparative advantage. The problems demanding immediate solution include the prompt provision of food, clothing, and shelter for the millions of persons displaced and impoverished by the war; the rehabilitation of farms, factories, and transportation facilities in the war-devastated countries, so that these people may begin at the earliest possible date to support themselves; the restoration and stabilization of currencies; the restoration of order to internal finances; the settlement of the problem of the sixteen billion dollars of blocked sterling balances; the termination of lend-lease and the settlement of lend-lease balances in such a way as not to disturb balances of international payments; the disposition of the overbuilt American merchant marine. Some of these matters are of more intimate concern to certain nations than to others. The settlement of the blocked sterling balances is, for example, first of all a British problem; the disposition of the American merchant marine, primarily a problem for the United States. Nevertheless, the solution of each one of these problems concerns all nations, for the way in which they are settled will vitally affect international economic relationships and the course of world economic history for a long time to come.

A vigorous attack has already been made on many of these problems, and the approach to several of them reveals a disposition toward international cooperation which is encouraging. The United Nations established a United Nations Relief and Rehabilitation Administration to deal with the immediate problems of furnishing relief to, and rehabilitating the economies of, devastated nations. The functions of UNRRA were assumed directly by the United Nations in 1947. An International Bank for Reconstruction and Development has been erected to insure private loans, and to make direct advances, for the reconstruction of countries ravaged by the war, as well as for the development of under-developed regions. An International Monetary Fund has been created to supervise the valu-

ation of currencies, and as a permanent agency to maintain stable foreign exchange relationships.

One of the most ambitious projects for the restoration of the world economy is provided by the Anglo-American financial agreement of December, 1945. Under the terms of this agreement, the United States Government, in order to assist in reestablishing the British monetary and trade position on a sound basis, agrees to extend to the British Government a loan of \$4,400,000,000, repayments to extend over a period of fifty-five years. The agreement also provides for (1) the settlement of United States-British lend-lease—the United States cancels \$25,000,000,000 of British lend-lease obligations, (2) the lifting of sterling area exchange restrictions from current transactions, (3) a program for the adjustment of the blocked sterling balances accumulated during the war, combining unfreezing, cancellation, and deferred payments, (4) an agreement on principles for restoring multilateral trade, and (5) plans for international trade conferences for putting these principles into practical application and for broadening their scope to include countries other than the United States and Great Britain. A portion of the loan (\$650,000,000) is to be used to pay for lend-lease goods in transit and delivered after V-J day and for the purchase of surplus United States war properties and installations in the United Kingdom. Similar credits for lend-lease settlements have been extended by the United States to France (\$575,000,000) and to Russia (\$400,000,000).

#### PERMANENT FOUNDATIONS OF A WORLD TRADING SYSTEM

The erection of a solid and permanent foundation upon which a vigorous, multilateral world trade can be developed and expanded along the lines dictated by comparative advantage depends upon the prevention of a rebirth of the spirit of protectionism, which dominated commercial policy in the period between the two wars. The growth of protectionism after the first World War was due to several factors, certain of which are likely to appear again and are difficult to eradicate. Chief among these were the feeling of political and economic insecurity—a natural heritage of the war, unemploy-

## 748 International Trade and Commercial Policy

ment and economic instability, insufficient regard for the interests of consumers, and the lack of an adequate reconstruction program. The problem of political security is dealt with briefly in the final section of this chapter.

The security that the people of the world today demand of their economic system comprises two desiderata: (1) high and constantly rising standards of living, and (2) a much greater degree of economic stability than they have yet been able to attain. It seems highly doubtful, however, whether, for most of the world, these two ends, especially rising living standards, can be achieved in the absence of a world trading system. The establishment and maintenance of such a system requires positive action on both a national and an international level for (1) the reduction of barriers to international trade, (2) the restoration of conditions ensuring effective equality of treatment for the commerce of all nations, and (3) the formulation of national policies designed to secure and maintain high levels of employment—and an effective international coordination of these national policies.

### (1) THE REDUCTION OF TRADE BARRIERS

A voluminous, multilateral world trade cannot exist unless the national trade barriers of the prewar years are drastically reduced. The very purpose of such barriers is to *diminish* trade. Moreover, the great changes which the war has caused in the structure of international claims and indebtedness require equally great changes in trade balances. Strong creditor countries need to maintain a high level of foreign investment in order to effect an orderly transition from a war to a peace economy, and to prevent a serious curtailment of employment in their export industries. The necessary expansion of exports by countries whose international financial position has deteriorated and which are forced to borrow heavily in the period of transition can be effected when these debts mature only if creditor countries are willing to accept an equivalent increase in their imports.

There will unquestionably be a need for the retention of quantitative trade restrictions and exchange controls by some countries during the period of recovery and rehabilitation in order to safeguard their currencies. But such controls should be removed as rap-

idly as conditions permit. Both quantitative restrictions and exchange controls involve dangers and disadvantages which are not compatible with a multilateral, non-discriminatory trading system. As long as they continue to be used, every precaution should be taken to ensure that their application is as liberal and non-discriminatory as it can possibly be made.

As quantitative controls are removed, there is grave danger that they will be supplanted by high tariffs. Such a substitution occurred after the first World War. The danger of such a trend toward high tariffs can be greatly lessened if high levels of economic activity and employment are maintained; if, in connection with reconstruction and the reconversion of industry, nations encourage only those lines of production that can stand on their own feet without tariff protection or subsidies; if national programs of readaptation are not left to be worked out by each nation independently, but can be developed by international consultation and planning; if the development of vested interests in trade barriers can be prevented during the transition period.<sup>11</sup>

Much can be done to adapt commercial policy to the great changes produced by the war through the spontaneous action of individual countries. Duties that do not protect any existing industry can be removed. Protection can be withdrawn from any industry which supplies only an insignificant portion of the national consumption of its product. Any industry enjoying tariff protection above a determined level can be required to make periodical reports to the tariff authorities upon measures taken to reduce costs and prices.<sup>12</sup> The protection to be accorded the industry could be periodically reconsidered on such a basis.<sup>13</sup>

The main hope of achieving a general demobilization of tariffs lies, however, in the conclusion of bilateral and multilateral trade agreements. Under such agreements, the immediate risks which the removal of existing trade defenses involves are offset by immediate openings for additional exports. The United States Trade Agreements program may well remain one of the main instruments of such

<sup>11</sup> See the League of Nations study, *Commercial Policy in the Post-War World*, pp. 39-40.

<sup>12</sup> This should not include wage reductions out of line with the country's general wage level.

<sup>13</sup> *Commercial Policy in the Post-War World*, p. 41.



## 750 International Trade and Commercial Policy

action. On December 6, 1945, the United States State Department presented to the United Nations proposals for the establishment of an International Trade Organization. This Organization would serve as a forum for the discussion of measures for the removal of trade restrictions and the coordination of national employment policies and would have an international staff to administer such arrangements as the Organization might adopt. An international conference on trade and employment to consider these proposals and to draw up a charter for such an Organization met in London during October and November, 1946.

A liberal trade program requires something more, however, than the elimination of quantitative trade restrictions and the reduction of tariffs. Care should be taken to see that the industrialization of under-developed areas proceeds cautiously, with due regard to local resources and comparative cost advantages. International consultation to consider the effects of particular developments in these countries upon commercial policies might be desirable. "Indirect protection" should be countered by urging national action to limit sanitary regulations, laws and regulations to protect business against unfair competition, and other similar regulations to their legitimate purposes. International agreement should be sought upon maximum guarantees which importing countries are justified in requiring from exporters. Customs nomenclature should be standardized and simplified. The greatest possible freedom for tariff reduction by contractual methods should be sought by discouraging the setting-up of non-negotiable tariffs and the placing of narrow legislative limits to the percentage cuts in duties that can be offered in return for reciprocal concessions.<sup>14</sup>

Finally, trade must be freed from restrictions imposed by private combines and cartels. We saw in Chapter XXII that international cartels can—without the aid, or even the consent, of governments—effectively control the international movement of their own products. The State Department's proposals for an International Trade Organization contain recommendations for the establishment of a special agency within the Organization "to receive complaints concerning restrictive practices of international combines and cartels, to obtain and examine the facts which are relevant to such cases,

<sup>14</sup> *Ibid.*, pp. 42-44.

and to advise the Organization as to the remedies that may be required." The elimination of most cartels by national governments on the basis of international agreement is desirable. Where this proves impossible, the registration of all cartel-type agreements could be required. The information contained in these agreements could then be made the basis for more comprehensive regulation by member governments or by the International Trade Organization itself.

In all matters concerning commercial policy, the interests of consumers should be zealously respected. Producer interests have been allowed to exercise an undue influence upon the formulation and application of commercial policies in the past, to the exclusion of consumer interests.

#### (2) EQUALITY OF TREATMENT

The restoration of conditions ensuring effective equality of treatment for the commerce of all nations is as essential for the development of a stable peacetime system of trade relationships as is the reduction of trade barriers. Measures which are directed specifically against the exports or traders of any country, which accord to the exports or traders of a certain country, or countries, special privileges not enjoyed by those of other countries, or which cause the importers of certain countries to pay more for goods imported from a given country than importers of other countries are obliged to pay will always be a source of ill will, and will be taken as justification for discrimination in other countries on grounds of retaliation or self-defense.

The elimination of discrimination in commercial policy involves:

- (a) the fullest and widest application of the unconditional most-favored-nation clause in all customs matters as well as in the treatment of foreign nationals and firms;
- (b) the removal of preferences, or the application of preferential systems only in accordance with agreed principles of policy;
- (c) the abandonment of discriminatory currency measures, except as and when permitted by international authority (the International Monetary Fund);
- (d) effective equality of treatment in the application of internal fiscal or other regulations affecting imports and exports;

## 752 International Trade and Commercial Policy

- (e) the allocating of quotas (including foreign exchange quotas) on as equitable a basis as possible between foreign countries;
- (f) the operation of state trading monopolies according to non-discriminatory principles;
- (g) the removal of discriminatory tariff classifications; and
- (h) the suppression so far as possible of 'unfair competition' and discriminatory practices by private cartels and monopolies.<sup>15</sup>

The attainments of these aims would be expedited if general agreement on principles could be secured.

Two of these objectives merit further comment. No system has yet been discovered by which import quotas can be allocated without injury to the interests of countries entitled to benefit under the most-favored-nation clause. The allocation of quotas between supplying countries in proportion to the imports received in some representative period seems to assure as equitable an allocation as the existence of quotas permits. But even this method of allocation has the disadvantage that it tends to freeze the sources of supply, to force the importing country to forego the benefits to be derived from a changing competitive situation, and to deprive efficient, new producers of a share in a profitable market. Observance of the following principles would do much to remove the stigma of discrimination from the allocation of quotas:

- (1) there should be no secret quotas;
- (2) the basis upon which quotas have been allocated should be made public at the time the quotas are announced;
- (3) the allotment of national quotas should be retained as a governmental function; it should not be delegated to some non-official agency, such as a trade association or cartel;
- (4) the basis of allotment should not be incapable of extension to at least all the major foreign sources of supply of the particular commodity involved;
- (5) countries should not negotiate concessions from other countries that can only be granted at the expense of third parties.<sup>16</sup>

<sup>15</sup> *Commercial Policy in the Post-War World*, League of Nations Publications, II. Economic and Financial. 1945. II. A. 7. p. 45.

<sup>16</sup> Jacob Viner, *Trade Relations Between Free-Market and Controlled Economies*, pp. 68-69.

The problems of tariff barriers and trade discrimination are posed in an acute form by state trading monopolies. This is the absolute form of state control over foreign trade. Russia has no need for tariff protection. Since the state does all the buying and selling in foreign markets, there can be no competition within Russia from foreign industries. If it is desired to exclude foreign goods, the state need only refrain from purchasing such goods; tariffs, import quotas, exchange controls, and prohibitions are unnecessary.

The state trading monopoly, like a commercial monopoly, is in a highly advantageous bargaining position when it deals with unorganized buyers or sellers. It may sell at different prices in different markets, and thus maximize its receipts. It may buy at different prices in different markets, and thus obtain its total supplies at a minimum cost. It may thereby extract the maximum advantage in its barter terms of trade. By threatening not to buy from another country, the state trading monopoly can, if it is an important buyer, obtain preferential advantages for its own products in the market of that country. It may compel a country to remove a tariff or other trade barrier against its goods, while the barriers are maintained against the products of a competitor. One thing may be said, however, for the foreign trading of a collectivist state, like Russia. It never pushes goods on the market simply to get rid of them; it does not, like capitalist countries, seek to sell as much as possible while striving to buy as little as possible.<sup>17</sup>

No formulae embodying objective criteria of discrimination appear to be available for dealing with state trading monopolies. It has been the practice to give and to exact in commercial conventions pledges of equitable and fair treatment by trading monopolies, and to request from the government maintaining such a monopoly sympathetic consideration to all representations that the other government may make with respect to alleged discriminations against its commerce in connection with purchases by such monopoly. The United States has used the following provisions in its conventions to elaborate these principles: "To this end it is agreed that in making its foreign purchases of any product such monopoly or agency will be influenced solely by those considerations, such as price, quality,

<sup>17</sup> See Calvin H. Hoover, *International Trade and Domestic Employment*, pp. 70-74.

## 754 International Trade and Commercial Policy

marketability, and terms of sale, which would ordinarily be taken into account by a private commercial enterprise interested solely in purchasing such product on the most favorable terms."<sup>18</sup> Where a difference of opinion over the carrying out of such pledges arises, the existence of international machinery should be helpful in providing consultation, objective appraisal of the facts, mediation, or even arbitration.

The early postwar period affords governments a highly favorable opportunity for reducing trade barriers and eliminating discriminatory commercial policies. During this period there will be a scarcity of goods in most countries, and imports will be sorely needed. It should therefore be possible to remove, or lighten, obstacles to trade without giving rise to opposition from those who in other circumstances might fear foreign competition. The great dislocations in the structure of industry and agriculture caused by the war will in any case make necessary a vast program of adaptation to peacetime conditions. Labor will be fully employed for some time to come in most countries. Where unemployment does exist, it will be caused by shortages of raw materials, capital equipment, and transportation facilities, not by foreign competition. Finally, there exists among the United Nations an experience in cooperation for war and a will to cooperate for peacetime ends.<sup>19</sup>

### (3) MAINTENANCE OF FULL PRODUCTION AND EMPLOYMENT

So long as national economic policies are based on fear, and not on confidence and mutual aid, they are bound to be essentially negative, restrictive, and self-destructive. Commercial policy during the inter-war period was largely shaped by two fears—the fear of mass unemployment and the fear of war. It was consequently defensive and anti-social in character. Unless we succeed in banishing these

<sup>18</sup> Quoted by Jacob Viner, *Trade Relations Between Free-Market and Controlled Economies*, League of Nations Publications, II. Economic and Financial, 1943. II. A. 4. p. 80.

<sup>19</sup> *Commercial Policy in the Post-War World*, pp. 61–62. The inability of the Big Three to find (November, 1946) a common ground upon which peace treaties with enemy states might be drafted, and Russia's policy of forcing the countries of eastern and southeastern Europe to sign trade agreements whereby practically all the exports of the latter are channeled into Russia, call for some tempering of this statement. Despite their failures, however, the great powers have refused to abandon their attempts to reach an agreement.

fears, we can expect at best only limited success from our efforts to reduce trade barriers and to abolish discriminatory trade practices.

Mass unemployment is a phenomenon of economic depression. During periods of prosperity and high investment, unemployment is never large, and occurs primarily because of economic friction or seasonal factors. The eradication of mass unemployment depends, then, upon smoothing out the curve of business activity, especially upon guarding against severe declines in production.

Prior to the Great Depression, governments had not recognized any definite obligation to maintain a high and stable level of production and employment. Such responsibility was suddenly thrust upon them by the catastrophic depression which engulfed the world in the early 1930's. Experimentation with anti-depression measures has revealed that cyclical fluctuations in business activity in an economically integrated world are not a national but an international phenomenon, that they require not only national but international action. Inspired by a desire to maintain a high level of employment at home in all circumstances, governments may pursue policies which not only give rise to unemployment abroad, but, by blocking the channels of trade and obstructing the productive transfer of funds, retard economic progress both at home and abroad.

Depressions have many causes. They vary in nature, and may require the adoption of different policies on different occasions. It is widely recognized today, however, that the level of employment in any industrial country depends upon the amount of expenditure. If insufficient is spent to buy the whole output that can be produced, at prices which cover the total costs of production, some people must become unemployed. Since the propensity to consume remains relatively constant at each level of income, the maintenance of demand—and consequently of employment—requires that the amount of expenditures directed to investment be large enough to offset the amount which people choose to save. When savings outrun investment, both production and employment decline. If a high level of production is to be sustained, therefore, prompt action must be taken to stimulate investment whenever investment tends to lag behind saving.

Many different policies may operate to stimulate private investment: the easing of credit, the repeal of repressive taxation, the re-

## 756 International Trade and Commercial Policy

duction of tax rates and social insurance premia, the correction of distorted cost-price relationships (e.g., the reduction of specific wage rates that may be out of line), the destruction of monopolies which produce supplies, raw materials, and machinery, as well as labor monopolies, the elimination of "feather-bedding" by labor unions. The expenditure of unemployment insurance funds may help sustain total spending, and thus indirectly encourage investment. If private investment does not respond sufficiently to such treatment, the government may inaugurate a program of public construction to supplement private investment. The program of public works should be carefully planned well in advance of any emergency and should include only projects the need for which is clearly recognized by the public. Wisely chosen foreign loans should be encouraged during depression, for, by raising income abroad, they tend to stimulate exports—without leading to trade restrictions by foreign nations. Budget deficits during depression are justified, provided taxes are raised sufficiently during prosperity to yield surpluses. But inflation should be avoided at all costs. Inflation breeds speculation, and speculation leads inevitably to collapse.

A heavy responsibility for the maintenance of a high level of world production and employment rests upon the major industrial countries, for world-wide depressions seem to result mainly from fluctuations in investment and employment in these countries. Depressions originating in such countries quickly spread to those countries that are exporters of crude products. The major industrial countries are the chief markets for the products of the latter, and are also their chief suppliers of investment funds. Consequently, a shrinkage of their export markets or the cessation of the inflow of investment funds quickly involves the smaller countries in balance-of-payments difficulties, provokes currency disorders, and causes national income and employment to decline. Autonomous action by exporters of crude products to avert depression must be of limited efficacy. In the past, internal recovery measures by these countries have involved restrictive trade controls, which have only helped shatter the weakened fabric of world relationships.

The avoidance of world-wide depressions thus depends upon the development of successful anti-depression policies by the major industrial countries. But, unless national policies are carried out by

common agreement and after joint and continuous consultation, there is a danger that they will run counter to each other, that one country will tend to spread depression abroad in an attempt to avoid it at home, and that the world will become divided into a number of militant, autarchic, national units. It is therefore of the utmost importance that the national policies for maintaining high and stable levels of employment should be coordinated and that adequate machinery for this coordination should be established.

The International Monetary Fund and the International Bank for Reconstruction and Development have already been established and should play an important role in coordinating currency and lending policies. The establishment of the International Trade Organization would be an invaluable addition to our international machinery for research, consultation, and policy making. Such an institution would have jurisdiction over a broad field of economic activity which does not fall within the jurisdiction of either the Bank or the Fund. It could study the fluctuations in economic activity in the various countries and analyze their causes; study the policies of the different governments that affect economic activity; keep governments and the general public informed concerning its findings and make recommendations to governments regarding measures to be pursued for reviving or maintaining economic activity; arrange for joint discussions with representatives of governments and of international bodies concerned with economic policy, with a view to formulating common anti-depression policies, as outlined in the two preceding sections, would also do much to stabilize and raise the level of employment.<sup>20</sup>

<sup>20</sup> The Economic and Financial Committee of the League of Nations have made an able, comprehensive, and constructive report on national and international anti-depression policies in *Economic Stability in the Post-War World* (1945). In addition to the proposals advanced herein, they recommend the establishment of a Buffer Stock Agency whose duty it would be to stabilize the prices of primary products through appropriate purchases, sales, and storage of specific products. Although price stability for such products is highly desirable, especially for the welfare of countries that export these products, the history of valorization schemes of this character does not inspire too great faith in the possible accomplishments of such an agency. Valorization schemes have, to be sure, succeeded for a time in holding prices above a competitive level. But in doing so, they have protected high-cost producers, encouraged over-production, and brought an inevitable break-down of the entire scheme. To be successful, any price-stabilizing plan must be extended to include the control of



**KEY POSITION OF THE UNITED STATES**

The United States holds a key position in the world economy. Upon this country rests the basic responsibility for taking the lead in international economic cooperation, the reduction of trade barriers, the elimination of all forms of discriminatory treatment in international commerce, and the restoration of a multilateral, world trading system. The productive efficiency of most branches of its industry is greatly superior to that of foreign industry; its domestic market is the vastest and richest in the world—before the second World War this country accounted for more than one-fourth of the world's production; its creditor position is unrivaled. The willingness of the United States to accept imports will have a profound influence upon the readiness of foreign nations to reduce their trade barriers and to abolish discriminatory trade practices. American capital is vitally necessary to the restoration of world production. But American foreign loans will, in the long run, bring a net benefit to the world only if this country is willing to import more than she exports in order to enable debtor nations to repay interest and principal. Failure of the United States to maintain a high level of production at home will have a depressing effect upon economic activity throughout the world.

The fundamental responsibility of the United States for securing international economic cooperation and maintaining world prosperity has been ably summed up by Dean Acheson, United States Assistant Secretary of State:

Many countries will feel that they cannot venture to commit themselves to the kind of international policy envisaged in Article VII unless they can be reasonably certain that the United States can be counted on to give these principles full support. They look for some assurance that this country will stand ready through the processes of trade and investment to make available to them goods that they will need; that we will maintain a high level of prosperity in this country and reduce our own obstacles to trade, so that they may have prospects of making repayment for the goods we sell to them. If we give this assurance and join with them in the maintenance of stability of the foreign exchanges, essential to

production. Furthermore, price-stabilization schemes have ignored consumer interests.

both investment and trade, then there is every prospect that they will be willing to join with us in these measures upon which depend the prospects of an increasing and stable prosperity throughout the world.<sup>21</sup>

American leadership in international cooperation has thus far given a good account of itself in the International Food Conference at Hot Springs (1943), the Bretton Woods Conferences (1944), the United Nations Meeting at San Francisco (1945), and the preparations for the international trade conference in 1946. But there still remain the additional tasks of further reducing our own trade barriers and of preventing domestic depression and mass unemployment.

### INTERNATIONAL TRADE AND WAR

Something more than international cooperation is necessary, however, if the reduction of trade barriers and the abolition of discriminatory trade practices are to make way for a truly international trading system. The threat of war must be banished from the world! The fear of war has been the greatest single deterrent to the pursuit of rational economic policies. A sense of political security is an indispensable prerequisite to the achievement of economic stability with a high standard of living.

Free access to the world's markets and sources of raw materials will help diminish the threat of war, for it will raise living standards and help maintain employment. Low living standards, depression, and unemployment breed discontent; and war germinates in discontent. Economic misery is all the more likely to breed war when one nation comes to believe that its troubles are caused by trade restrictions imposed by other nations, that its very national existence is imperiled by its inability to acquire foreign exchange from the sale of its products and to secure vital materials.

But the causes of war are not wholly economic. It is to be doubted if they are even primarily economic. "Founding an empire," "wresting the Holy Land from the infidel," "a place in the sun," "Deutschland über alles," "the divine obligation to become masters of the world" are not empty slogans. They are battle-cries! In them are summed up greed, hate, jealousy, rank nationalism, the lust for

<sup>21</sup> Department of State *Bulletin*, December 3, 1944. Quoted in *Commercial Policy in the Post-War World*, pp. 34-35.

## 760 International Trade and Commercial Policy

power. These are the real roots of war. Economic factors are frequently only rationalizations of aggression.

Man is again turning to organization and cooperation in an effort to save himself from the ravages of war. He tried this once before—in 1920, and failed. Can he hope to succeed this time? In organizing the United Nations, man is attempting to profit from his mistakes of a quarter-century earlier; he is trying to remedy the weaknesses in the old League of Nations Covenant. But the League need not have failed. It failed only because the will to peace was not deeply rooted in the hearts of men. The United Nations will succeed in abolishing war only if men and nations want peace strongly enough to sacrifice their petty, selfish interests for greater ends. One cannot help wondering whether the fear of annihilation by the atomic bomb, or by some even more hellish instrument of destruction, will cow men into doing what the humble, but universal, teachings of the Man of Nazareth have thus far failed to lead them into doing—composing their national differences by peaceful means.

### NOTE ON THE PURPOSES OF THE PROPOSED INTERNATIONAL TRADE ORGANIZATION

The purposes of the proposed International Trade Organization as set forth in the charter approved by the London conference in December, 1946, are: to promote the maintenance of employment in member countries; to expand opportunities for trade and economic development and to aid the industrialization of underdeveloped countries; to bring about the general relaxation and regulation of tariffs and other trade barriers and the elimination of trade discriminations, whether such barriers are imposed by governments or private organizations; to provide an orderly procedure under agreed rules for the negotiation of intergovernmental commodity arrangements; and to promote the cooperative solution of trade problems by creating permanent international machinery for consultation and collaboration.

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# Index

- Acceptances, bankers', 48; trade, 39  
Acts of Trade and Navigation, 27-28, 584-585  
Ad valorem duties, 251-254  
Adjustment mechanism, 142-143 n., 155-203  
    and International Monetary Fund, 722-725  
    items affected by, 273-275  
    under gold exchange standard, 730-731  
    under gold standard, 155-183, 697-699; long-run, 170-183; short-run, 166-169  
    under inconvertible paper currencies, 185-203, 704-705  
Adler, J. Hans, 607 n.  
Administrative delays in returning invoices, 356  
Administrative protectionism, 351-368; defined, 352; forms, 355-367; origins, 352-355  
Advantage, comparative vs. absolute, 98  
Agricultural Adjustment Administration, 223  
Air Commerce Act of 1926, 613  
Air transport, international, 609-615; costs and scale of production, 611-612; public aid to, 610-611; public control, 609-610  
Aliens, non-treaty rights of, 375-376  
Allocation, of foreign exchange, 467-469, 475; of import quotas, 445-450; of payments, 483-485, 497; of territories and industrial fields, 534, 549-550  
Alternative duties, 255-256  
American merchant marine, 574-575, 576-577, 602-603, 606, 607-609  
    policy, 595-606; before Civil War, 595-598; Civil War to World War I, 598-600; since World War I, 600-606  
American Stabilization Fund, 710-711, 712  
Angell, James W., 156 n., 166 n., 187 n.  
Anglo-American agreement on petroleum, 566 n.  
Anglo-American financial agreement of 1945, 747  
Animals and animal products, control of imports of, 362-363, 750  
Anti-depression policies, 755-757  
Anti-dumping duties, 525, 526, 527 n.  
Anti-dumping laws, 509 n., 526-528; appraisal of, 527-528  
Antitrust legislation, United States, 564-565  
    "Apostles of expansionism," 623  
Arbitrage, 73-76; interest, 79-81; three-point, 75-76; two-point, 74-75  
Argentina, system of exchange control, 474-476  
Argol agreements, 407  
"Aski" marks, 473-474  
Assimilation, tariff, 624-625; explained, 624-625; value of, to colonies and mother country, 625  
Balance of international payments, 56-60, 156-159; and International Bank for Reconstruction and Development, 689-690; defined, 56; effects of import quotas on, 444-445; "favorable" and "unfavorable," 159; nature of, 57-60; of the United States, 1939-1940, 58-59  
Balance of trade, active, 60  
    and balance of payments, 60-62  
    and capital export, 676-677  
    effects of import quotas on, 444  
    "favorable," 23, 27, 60-61  
    mercantilist views of, 23-24  
    passive, 60

- Balance of trade—(*Continued*)  
 relation of, to changing investment position, of Great Britain, 61-62; of the United States, 62  
 "unfavorable," 23, 60-61  
 Baldwin, Stanley, 307-308  
 Bank of England and capital export, 668-669  
 Banking services as source of demand and supply of exchange, 50-51  
 Banking systems, national, 5  
 Barcelona Statute on Freedom of Transit, 219, 374  
 Bargaining tariffs, 393-424; and Reciprocal Trade Agreements, 418; concessional and penalty, 394-395  
*See also* Tariff bargaining  
 Barter terms of trade, *see* Terms of trade  
 Bastable, C. F., 131-132  
 Beard, Charles A., 736 n.  
 Berlin Conference on the Congo, 620  
 Beveridge, Sir William, 287, 299, 301 n., 309, 311 n., 527  
 Bidwell, Percy W., 351 n., 353 n.  
 Bilateralism, 431, 473, 478, 480, 489-493, 500-503, 744  
 Bill of lading, 38, 39, 39 n.  
 Bills of exchange, acceptance of, 39; bankers' acceptance, 48; bankers' bills, 44, 45; clean bills, 45; commercial bills, 44, 45; defined, 38; discounting of, 40; documentary, 45; facsimile, 39; long, 45; short, 45; sight, 45; trade acceptance, 39; use of bankers' long bills, 55  
 Birth control, 637  
 Blocked accounts, 469-474, 666; and clearing agreements, 481, 482, 485; and foreign investments, 666; British, 729, 746  
 Bober, M. M., 120 n.  
 Bonded warehouses, 342-345; entrepôt fictif, 343, 344; entrepôt réel, 343, 344; government and private, 342-343; in United States, 343-344; manufacture under bond, 343-344  
 Borkin, Joseph, 551 n., 560  
 Bounties, 23, 24, 263-269  
 distinction between pure and compensatory, 268-269  
 export, 266-269; effects of, 267-269  
*See also* Subsidies  
 Bounty dumping, 510, 511  
 Boycotts, protective, 366-367  
 Brazilian agreement of 1923, 408  
 Bretton Woods Conferences, 686, 687 n., 717, 759  
 British Cinematograph Films Act of 1938, 367  
 British Exchange Equalisation Account, 711-712  
 British Merchandise Act, 361  
 Brussels Sugar Convention of 1902, 374  
 Budget deficits, 195-196  
 Buffer Stock Agency, 757 n.  
 "Bullionism," 22-23  
 Bülow, Chancellor, 623  
 Business booms as source of disturbance in balance of payments, 180  
 Business fluctuations and capital export, 685-686  
 "Buy at home" campaigns, 366-367  
 Cairnes, J. E., 126  
 Canadian reciprocity treaty of 1854, 401-402; negotiations of 1910, 402-403  
 Capital, defined, 655-656; procurement of, by shipping industry, 591-592; productivity of, 658-659  
 Capital charges, 111-116, 126  
 Capital export, 659 n.  
 economic effects of, 676-686  
 government encouragement to, 673-674  
 incentives to, 658-661; economic, 658-659; political, 659  
 nature of, 655-658  
 net, 177, 657  
 Capital movements, 161-163, 239, 655, 649-692, 700  
 and business fluctuations, 685-686, 703-704

- Capital movements—(*Continued*)  
 and exchange control, 477  
 long-term, 53-54, 161, 170-180, 193-194, 202  
 short-term, 44, 54-56, 156-159, 160, 161-163, 166 n., 166-169, 170, 176, 182 n., 203; disequilibrating, 55-56, 162-163, 430; equilibrating, 55, 156-158, 161-162, 166-169, 170, 198, 203, 702 n.  
 to colonies, 629-630, 674  
 Capital repayments, 61-62, 651, 673, 675-676, 758; and terms of trade, 682-683  
 Capitalism, cause of imperialism, 621  
 Cartels, 529-570; compared with pools, 531; defined, 531-534; International Rubber Regulating Committee, 532-533; International Steel Cartel, 533-534  
*See also* Combinations, international  
 Cassel, Gustav, 186-187 n., 193 n.  
 Cellar Act of 1934, 349  
 Central banking, operations, 165, 167; policy, 700, 731 n.  
 Chamberlain, John, 736 n.  
 Circular velocity of money, 171  
 Clark, Grover, 636, 643  
 Classical theory of international trade, 84-103; compared with mutual interdependence theory, 138; criticism of, 128-133; refinements of, 104-126, 133  
 Clearing agreements, 483-493  
 duration, 484  
 effects of, 499-504; on trade balances, 485-489  
 German manipulation of, 489-493  
 in postwar period, 504 n.  
 mechanism of, 483-485  
 origins of, 482  
 political dangers of, 503  
 Coastwise shipping, 585, 600  
 Cobden-Chevalier Treaty, 245-246  
 Colonial development, 618-621; ancient, 618-619; modern, 619-621  
 Colonial economic policies, 624-632; economic development, 629-631, Colonial economic policies—(*Cont.*)  
 634; labor policy, 631-632; shipping policy, 628-629; tariffs, 624-628  
 Colonial expenses, 643  
 Colonial financial policy, 641 n.  
 Colonial production, of foodstuffs, 647; of raw materials, 646  
 Colonial trade, 616 n., 621, 641-644  
 Colonies, 616-647; and war, 644-645; as markets for mother country, 641-644; as sources of raw materials, 637-641; cost of acquisition, 635; do they pay? 632-647; in the system of mercantilism, 26-27; location and products of, 618; methods of acquiring, 621; political bases of, 622-624, 646-647; why sought? 621-624  
 Colonization, economic effects of, 633-635  
 Colony, defined, 617  
 Combinations, international, 529-570, 750; alleged economies of, 544-545; allocation of industrial fields and national markets, 549-550; and inefficient plants, 553; and the tariff, 554-557; appraisal of, 563-564; conditions conducive to, 539-540; defined, 531; economic policies and practices of, 546-553; exchange of patents, 551; goals of, 544-546; impairment of quality by, 547-549; of productive factors, 130-132; patent suppression by, 552-553; political aspects of, 557-562; price control by, 546-547; restriction of supply, 550-553, 559-561; suggested postwar policy toward, 564-569; types of, 530-539; ways of weakening independents, 553  
 Combines, 536-539; chemicals, 538; defined, 536; electrical equipment, 537-538; in rayon industry, 536-537; International Telephone and Telegraph Company,



**Combines—(Continued)**

537; linoleum, 537; Unilever, 537

Commercial policy, defined, 215

Commercial treaties, 372-392; bilateral and multilateral, 374-375; content of, 373; defined, 372; direct and indirect agreements, 375; duration of, 373-374; forms of, 372-373; interpretation of, 391-392; merits and weaknesses of multilateral, 374-375

Committee on Reciprocity Information, 412

Commodity agreements, international, 566-568, 568-569, 570

Comparative advantage, 99, 101, 109, 114, 115, 120; and many commodities, 120-123; more than two countries, 123-124

Comparative costs, theory of, 90-103

Compensation agreements, 493-497; compared with clearing agreements, 494-495; disadvantages of, 495; governmental, 496-497; private, 493-496

Compensation clause, 488-489

Compensatory duties, 258 n.

Competition, 529-530, 578-579; advantages of, 89-90; imperfect, 516-518, 530; pure, 134-136

Compound duties, 251

Condliffe, J. B., 463 n., 492-493, 732 n.

Constant costs, 116

Construction Loan Fund, 601, 602

Consumer interests, 566-567, 751

Cooperation, international, basis of sound world economy, 742-745, 760; monetary, 714-717, 727-728; on cartel problem, 568

Cost-differences, 737-738; absolute, 93-98; and domestic goods, 105-106; comparative, 98-101; equal, 101-103, 108-109

Costs, air transport, 611-612

constant, 116, 224, 225

decreasing, 118-120; and protection, 309-313; and terms of trade, 120

**Costs—(Continued)**

increasing, 116-118; and incidence of import duties, 225-228; and international specialization, 117-118; and terms of trade, 116-117, 126; and protection, 309-313

of transport, 105, 143-145, 160, 239, 572-573

real, 131-132

relative, 91-92

shipping, 572-573, 581, 583, 585, 597, 598-600

Countervailing duties, 269

Court of Customs and Patent Appeal, 357, 359

Crane, John B., 611-612

Credit crisis of 1931, 157, 162, 207, 430, 459, 460

Creditanstalt failure, 162, 430, 459, 460

Creditor countries, postwar obligations of, 748

Cuban reciprocity treaty of 1903, 403-404

Culbertson, William Smith, 379, 386

Currency depreciation, 427

Currency systems, national, 5

Customs, national and international trade, 9

Customs areas, 242-243; customs union, 243; customs annexation, 243; frontier areas, 242-243

Customs Court, 357, 360-361

Customs formalities and administration, oppressive features of, 355-360

Customs nomenclature, 256-261, 750

Cyclical fluctuations of general business, 161; and capital export, 685-686

Darmstadter und National Bank failure, 162, 430

Dawes Commission, 163

Dealers in foreign exchange, 38, 39, 40; avoidance of risk of exchange by, 40-41; source of profit, 41

Decker, Matthew, 19

Decreasing costs, 118-120; and pro-

- Decreasing costs—(*Continued*)  
 protection, 309–313; and terms of trade, 120
- Default in debt repayments, 682
- Deficit countries and International Monetary Fund, 722–723
- Deflation, 462; as means of restoring equilibrium, 460–461; bias of gold standard toward, 704
- de Haas, J. Anton, 238
- Demand and supply of exchange, 44 n., 50–56, 65–67, 96, 190–192
- Demand schedules, shifts in, 170, 176
- Department of Agriculture, 363
- Department of Commerce, 652 n., 653
- Department of Justice, 530, 540 n.
- Depreciation charges, 111–112
- Depressions, 755; and protectionism, 428–431; counter policies, 755–757; responsibility of the major industrial countries, 756–757
- Diebold, William, Jr., 424 n.
- Dietrich, Ethel B., 617
- Diminishing returns in agriculture, and international trade, 736–737, 741–742
- Diplomacy, and foreign lending, 674–676; international air transport, 612–613
- Direct investments abroad, of United States, 665–667
- Discrimination, elimination of, 751–754; in colonial tariffs, 625–627; in port and tonnage dues and fees, 596, 597, 629; in shipping policy, 629
- Disequilibrium in balances of payments, 159–163, 163–164, 170–181; and International Monetary Fund, 722–725
- Divisibility of productive factors, lack of, 149
- Division of labor, advantages of, 84–87; and trade, 1–3; international, 2–3, 84–90
- Domeratzky, Louis, 553 n.
- Domestic goods, 104–107  
 and changes in national price levels, 105–106
- Domestic goods—(*Continued*)  
 and costs, of production, 105; of transportation, 105  
 and proximity to consumers, 104  
 prices of, and standard of living, 106–107
- Domestic trade, 1, 84–85; compared with international, 3–4
- Drafts, *see* Bills of exchange
- Drawbacks, 335–339; compared with export bounties, 338–339; in United States, 336
- Dumping, 507–528; bounty, 510, 511; concealment of, 508–509; conditions necessary for, 511–512; consequences of, to importing country, 522–524; effects of, on prices in exporting country, 512–522; “exchange,” 509; “freight,” 509 n.; long-run, 510–511, 513–514, 524, 527; measures to combat, 524–526; nature of, 507–509; of producers’ goods, 521–522; predatory, 510 n., 523; reverse, 508; short-run, 510, 513, 523–524, 527; sporadic, 509–510, 513, 523, 527; “spurious,” 508; “trade-cycle,” 513 n.
- Dumping price, 514 n.; theory of, 518–521
- Duties, ad valorem, 251–254  
 alternative, 255–256  
 compensating, 258 n.  
 compound, 251  
 concessional, in United States tariff acts, 405–407  
 countervailing, 269  
 distinction, between ad valorem and specific, 251; between revenue and protective, 217–219  
 export, 232–239, 542, 627–628  
 penalty, in United States tariff acts, 405–407  
 specific, 254–255  
*See also* Preferential duties
- Earnings on investments, 52–53
- Economic and Security Council of the United Nations, 728
- Economic planning, 419, 455; and

- Economic planning—(*Continued*)  
 Reciprocal Trade Agreements, 419
- Economic security, and industrialization, 14-15; and trade restrictions, 14-15
- Economic trends and international trade, 742
- Economies, alleged, of cartels, 544-545; and large-scale production, 118-120, 149, 310-313, 684  
*See also* External economies; Internal economies
- Edminster, Lynn R., 541
- Edwards, Corwin D., 530 n., 531 n., 535-536, 546, 548, 551 n., 552 n., 566 n.
- Einzig, Paul, 499 n., 501
- Elasticity, of demand and supply, 228-229, 238; of demand for exports, 183, 699
- Electricity and international trade, 737
- Ellis, Howard S., 468 n., 480 n.
- Ellsworth, P. T., 166 n., 301 n., 502, 737
- Emergency Fleet Corporation, 600
- Emergency Tariff Act of 1921, 426
- Emigration to colonies, 636-637
- Empire preference, British, 249-250, 626
- Entrepôt, fictif, 343, 344; réel, 343, 344
- Equality of treatment, 751-754
- Equilibrium in balance of payments, 156-159; sources of disturbances of, 159-163
- Exchange control, 417, 418, 428, 457-479, 480; compared with import quotas, 459; degrees of, 463-466; effects of, 476-478; nature of, 457-459; preferential allocation, 468-469; purposes of, 459-463; technique of, 463-469
- Exchange depreciation, 204-213, 283, 418-419, 461-462; and balances of payments, 461-462; and price changes, 204-213; as recovery measure, 205-212; involuntary, Exchange depreciation—(*Continued*)  
 204; Japanese, 283; voluntary, 204-205
- Exchange dumping, 509
- Exchange stabilization funds, 709-713; credit type, 711-712; gold type, 710-711, 712
- Exemption, from import duties, 333-335; from transit duties, 345-346
- Export credits guarantee, 664
- Export Credits Guarantee Department of the Board of Trade, 664
- Export duties, 232-239, 542; as revenue producers, 233-234, 542; colonial, 627-628; effects of, on prices and output, 237-239; prohibited in United States, 233; protective, 234-237
- Export-Import Bank, 671-672
- Export prohibitions, 235 n.
- Export quotas, 541, 550
- "Export value," 357-358
- Export restrictions, 24-25, 541
- Exports, defined, 50; as percentage of total production of United States, 10-11
- External economies, 118-120, 310-313
- Favorable balance of payments, 159
- Favorable balance of trade, 23, 27, 60-61
- Federal Farm Board, 541
- Federal Trade Commission, 527 n., 544
- Feis, Herbert, 659 n.
- Ferry, Jules, 641
- Financing foreign shipments, 38-42, 45-49; "advance collection," 46; by exporter, 46; by importer, 46; "refinancing acceptance," 46
- Fisher, Allen G. B., 568 n.
- Flexibility of cost-price structures, 699, 702
- Flexible exchange rates, 71-73, 198-199, 202, 696, 704-709
- Flight of capital, 204 n., 464, 467, 479

- Food and Agricultural Organization, 569-570
- Foreign exchange, 36-83; an offsetting of foreign debts and credits, 42-44; and colonies, 640-641; definition, 38 n.; forward, 76-83, 707; functions of, 36-37; mechanism of international payment, 36-62; triangular clearance, 43
- Foreign exchange rates, 64-83, 140-141  
 defined, 64  
 fixed, 695, 696  
 flexible, 695, 696, 704-709; advantages of, 705-706; disadvantages of, 706-709  
 on forward exchange, 78-81  
 relationship of different, in a given market, 64-65  
 under inconvertible paper currencies, 185-186, 197-198
- Foreign Funds Control, 467 n.
- Foreign trade, importance of, to Great Britain, 9-10; to United States, 9-11
- Foreign-trade fleets, 603; United States, 602-603, 606, 607-609
- "Foreign value," 357-358
- Franco-German indemnity of 1871, 163, 466
- "Free capital disposal," 656
- Free enterprise, 743-744
- Free ports, 346-350; compared with free zones, 346-347; in Middle Ages, 346; in United States, 348-350; manufacturing in, 347-348
- Free trade, 128, 271; Adam Smith's views on, 30-31; and maximization of national income, 87-90; and monopoly, 89-90; the case for, 84-103, 271
- Free zones, 346-350; compared with free ports, 346-347
- Freedoms of the air, 613-614
- Freight dumping, 509 n.
- Full employment, maintenance of, 754-757
- Future of international trade, 735-760
- Futures, foreign exchange, 76-83; a means of avoiding risk of exchange, 76-77; and hedging, 79-81; and speculation, 81-83
- Gain, from foreign lending, 677; to borrowing nation, 677-679; to lending nation, 679-682  
 from trade, 87-90, 93-94, 97, 98-99, 122, 147-149
- Gee, Joshua, 19
- Geneva Convention of 1930, 374
- Genoa Conference of 1922, 731
- German Customs Union, 220
- German reparations, 195-196
- Germany's use of clearing agreements, 489-493
- Gold, as adjustment item, 156-159, 181-182; as state treasure, 21; and growth of trade, 20; and saving, 21-22; export restrictions on, 22-23; how to acquire, 22-23; identified with wealth by mercantilists, 18-22; only one form of wealth, 34; sinews of war, 20-21
- Gold bloc, 713
- Gold exchange standard, 729-732; adjustment of disequilibria under, 730-731; compared with gold standard, 730; in inter-war period, 732; inflationary bias of, 731; weaknesses of, 731-732
- Gold-flows, 22, 23, 33-34, 44, 69-71, 96, 122, 156-159, 160, 164-166, 182 n., 460; sensitivity of national monetary circulations to, 699
- Gold points, 69-71, 157, 164
- Gold-producing countries, 158 n., 159 n.
- Gold standard, abandonment of, by Great Britain, 162; adjustment mechanism under, 155-183; and expanding economy, 700; before 1914, 700; conditions essential to smooth working of, 699-700; essence of, 67-68, 696, 697-703; experience with, after World

- Gold standard—(Continued)**  
 War I, 700–701; shortcomings, 700–704
- Gordon, Margaret S., 433 n., 437 n., 448 n., 471 n., 481 n.
- Government control of international trade, 744–745
- Government ownership, 565; of shipping, 593–595
- Graham, Frank D., 309–310
- Great Britain, abandonment of gold standard by, 430; changing investment position of, and balance of trade, 61–62
- Grunzell, Josef, 353, 365
- Guarantee of loans by International Bank for Reconstruction and Development, 687, 690, 691–692
- Haberler, Gottfried von, 227 n., 235 n., 261 n., 263 n., 268, 285 n., 323–324, 389–390, 437 n., 449, 520 n.; theory of international trade, 152–153
- Halm, George N., 702 n., 715 n., 716 n., 724 n., 732 n.
- Hamilton, Alexander, 265–266, 295, 296, 314
- Hansen, Alvin H., 568 n., 700
- Harms, 530
- Harris, C. R. S., 471 n.
- Harris, S. E., 205 n., 208–212
- Hawaiian reciprocity treaty of 1875, 403; renewal, in 1885, 403
- Hawley-Smoot Tariff Act of 1930, 218  
*See also* Tariff Act of 1930
- Healy, Kent T., 611 n.
- Heaton, Herbert, 18, 26 n.
- Henderson, H. D., 633 n.
- Heuser, Heinrich, 435 n., 437 n., 444–445, 476, 477
- Hexner, Ervin, 534 n., 537 n.
- Hodgson, R. A., 263 n.
- Hoover, Calvin B., 568 n., 609 n., 745, 753 n.
- Hoover moratorium, 162
- “Hot money,” 655, 660–661
- Hull, Cordell, 409–410
- Hume, David, and theory of international prices, 33–34, 163
- Hutchins, John G. B., 576 n., 578, 582 n., 585 n., 589 n.
- Immigrant remittances, 52, 161
- Immigration, and foreign lending, 678–679; restrictions on, 8
- Impairment of quality by cartels, 547–549; electric bulbs, 548; methyl methacrylate, 548; pigment, 548–549
- Imperialism, 31, 621
- Import balance, disappearance of, under clearing agreements, 485–487
- Import certificate, 267
- Import duties, and terms of trade, 125; as revenue producers, 220–222; effects upon prices and production, 220–232
- Import monopolies, 418, 452–454, 744
- Import quotas, *see* Quotas, import
- Imports, and exports, relation between, 36; defined, 50; importance of, to United States, 11; improper appraisal and classification of, 356–357
- Improvement trade, 339–341; active, 339–341; compared with drawbacks, 339–340; passive, 341
- Income changes, 96, 99
- Increasing costs, and dumping, 520; and import duties, 225–228; and international specialization, 117–118; and terms of trade, 116–117, 126; and theory of comparative costs, 116–118
- Indemnities, 163
- Indices of height of tariffs, 261–263
- Indirect protectionism, 351–368, 750; defined, 352; origins of, 352–355
- Industrialization, of agricultural countries, 740, 750; of colonies, 630, 633–634, 637; of low-wage countries, 281–286
- Inflation, 196, 197, 204, 208, 756; and gold exchange standard, 731

- Informal corporate arrangements, 538-539; aluminum, 538-539; Rohm & Haas, 538
- Insurance services as source of demand for and supply of foreign exchange, 52
- Interest charges, 112-116, 126, 130, 161
- Internal economies, 118, 119, 310-313
- International Bank for Reconstruction and Development, 670, 685, 686-692, 717, 746, 757; liabilities of members, 690; management, 688; membership, 687 n.; objectives, 687; protection of balances of payments, 689-690; quality of loans by, 688-689; soundness of, 690-692; sources of capital, 687-688
- International Civil Aviation Organization, 613
- International combinations, *see* Combinations, international
- International Conference on Civil Aviation of 1944, 613-615
- International Convention for Air Navigation of 1919, 612
- International cooperation, basis of sound world economy, 742-747, 756-757; monetary, 714-717, 727-728; on cartel problem, 568
- International Court of Justice, 391
- International Food Conference, 759
- International Monetary Fund, 213, 283, 479, 670, 716, 717-729, 746-747, 751, 757; a reserve of international currency, 718-722; and deficit countries, 722-723; automatic adjustment forces, 724-725; international consultation, 725-726; limitations on use of resources, 719-721; purchasing privileges of members, 720; purposes of, 717-718; replacement of resources of, 720-721; role of gold in, 719; security behind loans to members, 721-722; surplus countries, 724; transition period, 726-727
- International prices, theory of, David Hume, 33-34; John Locke, 33
- International Rubber Regulating Committee, 532-533, 541
- International Steel Cartel, 533-534
- International trade, and division of labor, 2-3; and political forces, 13-15; and technology, 11-13; are foundations crumbling? 736-742; distinctive characteristics of, 4-9; future of, 735-760; national regulation of, 4-5; similarity of to domestic trade, 3-4
- International Trade Organization, 422, 568, 750-751, 757, 760
- Internationally traded goods and domestic goods, distinction between, 104-107
- Interregional analysis, 134 n.
- Investment, international, 649-692
  - and International Bank for Reconstruction and Development, 688-689
  - and the state, 667-676
  - economic effects of, 676-686
  - government encouragement to, 673-674
  - position of United States, 653
  - risks of, 667
  - significance of, 649-650, 677
  - types of, 661-667; internal and external, 661-662; long, medium, and short, 663-664; portfolio and direct, 664-665; private and governmental, 661; productive and unproductive, 662-663
- Investment bankers, and capital export, 659-660
- Investments, colonial, 631, 674; distribution of United States, 654
- Invisible items in balance of payments, 50, 143 n.; recognition of, by mercantilists, 27; relationship to merchandise balance, 61-62
- Invisible tariff, 351-368; defined, 352; origins of, 352-355
- Invoices, administrative delays in returning, 356

- Ise, John, 515 n.  
 Iversen, Carl, 166 n., 656
- Jefferson, Thomas, and natural rights, 29
- Johnson Act, 670, 673
- Joint Statement by Experts on the Establishment of an International Monetary Fund, 717 n.
- Jones-White Act, 602-603
- Kasson agreements, 407
- Kemmerer, Edwin Walter, 732 n.
- Keynes, J. M., 305, 682, 691, 717 n., 732 n., 736
- Killough, Hugh B., 7
- Kindleberger, Charles P., 166 n., 710 n.
- "Know-how," 535, 551, 553, 563
- Labor-cost theory of value, 91-92, 107-108, 128-129, 132-133
- Labor costs, and labor unions, 280-281; and minimum wage legislation, 279-280
- Labor policy, colonial, 631-633
- Labor unions, and labor costs, 280-281; and real wages, 326
- Laissez-faire, 30-31
- Landing certificate, 337 n.
- Landing rights, 612-613
- Large-scale production and international trade, 149, 681-682
- Laws, international differences in, 9
- League of Nations, 260-261, 685, 741, 749 n., 752 n., 757 n., 760
- "Leaks" in flow of purchasing power, 302
- Lend-lease, 163, 672-673, 746, 747
- Lenders, international, 650-655, 691; and the International Bank, 687, 691; France, 650, 651, 680 n.; Germany, 650, 651; Great Britain, 650, 651; United States, 651, 652-655
- Lending, international, 429-431, 459-460; and fluctuating exchanges, 707-709  
*See also* Capital movements
- Letter of credit, 47-49; advantages of, 48-49; defined, 47; irrevocable and confirmed, 47-48, 49; revocable, 49; revolving, 49; travelers', 49; unconfirmed, 49
- Letting of public contracts, effects of, upon imports, 365-366
- Lewis, Cleona, 654
- Licensing of imports, 432
- Liefman, 530
- Linked-purchasing regulations, 450-451
- Linked-utilization measures, 450
- Lissitzyn, Oliver James, 611 n.
- List, Friedrich, 219-220, 295-296, 297
- Loan councils, 674
- Location of industry, 143-145, 149  
 of shipbuilding, 581-583; and shipping policy, 575-576
- Locke, John, and natural rights, 29; and quantity theory of money, 33
- Locklin, D. Philip, 231 n.
- Long-term international loans, 53-54; and balance of trade, 61-62; reasons for, 54
- Luthringer, George F., 732 n.
- McKenna Duties, 426
- Machlup, Fritz, 166 n., 172 n., 173 n., 174 n., 176 n.
- Mandates, 621
- Marginal cost, declining, and dumping price, 519-520; defined, 516 n.; rising, and dumping price, 520-521 n.
- Marginal revenue defined, 516 n.
- Maritime Commission, United States, 576-577, 578, 583, 595, 604, 605-606, 607
- Marketing regulations discriminatory against foreign products, 367
- Marks-of-origin requirements, 360-362; purpose of, in United States, 360 n.
- Marshall, Alfred, 299
- Mason, Edward S., 563 n.
- Materials as a cost, 125, 126
- Medium-term credits, 664, 672, 674

- Mercantilism**, 14, 16-17, 16-34  
 and balance of trade, 18, 23-24  
 and bounties, 23, 24  
 and colonies, 26-27, 619  
 and export restrictions, 24-25  
 and merchant marine, 27-28  
 and migrations of workers, 24  
 and precious metals, 18-23  
 and quantity theory of money, 33-34  
 and reexport trade, 25  
 and sumptuary laws, 23  
 critique of, 32-34  
 ebb of, 28-31; laissez-faire, 29-31;  
   the political philosophers, 29  
 export restrictions on gold, 22-23  
 labor policies of, 25-26  
 modern, 31  
 nature of, 17-18  
 recent defenses of, 32  
 recognition of invisible items in  
   balance of payments, 27  
**Mercantilist policies and doctrines**,  
 18-28  
**Merchant marine**, 746  
   case for a national, 573-580; mili-  
   tary defense, 573-575, 580; to  
   promote nation's foreign trade,  
   576-580; to promote political and  
   economic interests of nation,  
   575-576  
   in system of mercantilism, 27-28  
   policies, 572-609  
   state support to, 584-595  
**Merchant Marine Act of 1916**, 600  
**Merchant Marine Act of 1920**, 601-  
 602  
**Merchant Marine Act of 1928**, 602-  
 603  
**Merchant Marine Act of 1936**, 591,  
 595, 603-606  
**Merchants and mercantilist doctrines**,  
 28-29, 32-33  
**Meyers, Albert L.**, 515 n.  
**Migrations of workers**, 5-9; and mer-  
 cantilism, 24  
**Mill, John Stuart**, 94, 126  
**Milling regulations**, 451-452  
**Minimum wage legislation and labor  
 costs**, 279-280  
**Miscellaneous items of demand and  
 supply of exchange**, 52  
**Misselden, E.**, 19  
**Missionaries and colonies**, 622-623  
**Mlynarski, Felix**, 732 n.  
**Mobility of labor and capital**, 5-9,  
 91, 98  
**Modern productive techniques, and  
 agriculture**, 740-741; diffusion  
 of, and international trade, 736,  
 737  
**Mond, Sir Alfred**, 539-540, 551  
**Monetary cooperation, international**,  
 714-717; principles of, 715-716  
**Monetary management**, 418  
**Monetary mechanism, international**,  
 criteria of, 695-696; gold stand-  
 ard, 67-68, 697-699  
**Monetary policy**, 694-695, 700, 701-  
 702  
**Monetary problem**, 694  
**Monetary relationships, international**,  
 694-732  
**Money costs as basis of international  
 trade theory**, 133, 134  
**Money incomes, in mechanism of ad-  
 justment**, 164, 171; secondary ex-  
 pansion of, 172-173, 176  
**Money wages**, 95, 96, 97-98, 99-  
 101, 102, 103, 106-107, 108-109,  
 121-122, 124; domestic differ-  
 ences in, 107-111  
**Monopolies**, 89-91, 238-239, 506-  
 507, 539-540  
   and dumping, 511-512, 512-513  
   camphor, 541, 542  
   foreign trade, 418, 452-454, 744  
   import, 452-454  
   navigation, 584-587  
   nitrates, 541, 542-543  
   of raw materials, colonial, 639;  
   private, 541; state, 541  
   rubber, 532-533, 542  
   state trading, 744, 752, 753-754  
**Monopoly price, on steel**, 579; reduc-  
 tion of, 522; theory of, 514-518  
**Moratoria and balances of payments**,  
 461  
**Most-favored-nation clause**, 259, 379-  
 391, 408, 413-415, 417-418,



- Most-favored-nation clause—(*Cont.*)  
 751; advantages of unconditional form, 386-390; and anti-dumping duties, 526; and quotas, 447; attacks on unconditional form, 387-389; conditional and unconditional, 381-383; disadvantages of conditional form, 384-386; exceptions to, 390-391; in Reciprocal Trade Agreements, 413-415, 417-418; nature of, 379-380; unilateral and bilateral, 380-381; "unrestricted" and "restricted," 380
- Multangular trade, 477-478, 500-501, 735, 744, 747, 748, 758; and clearing agreements, 500-501
- Multilateralism, *see* Multangular trade
- Multiple-rate systems in South America, 474-476
- "Multiplier," 301-304
- Mund, Vernon A., 286 n.
- Mussolini, Benito, 623, 643 n.
- Mutual interdependence theory, of pricing, 134-136; of international trade, 137-143
- National income and foreign lending, 677, 678, 680, 684
- National Socialism, 462-463
- National treatment, 376-379; exceptions to, 377-378; in Spanish-American treaty of 1922, 377 n.; not reciprocally equal, 378; reciprocal and unilateral, 376-377
- Nationalism, 14, 573, 583, 614-615, 666; and colonies, 623, 641; and foreign investment, 666; and shipping, 573, 583
- Natural resources, 6, 86, 139, 541
- Naval bases, use of colonies for, 622
- Navigation Act of 1817, 597
- Navigation Acts, *see* Acts of Trade and Navigation
- Neutrality Acts of 1936 and 1937, 670-671, 673
- Nomenclature, tariff, 256-261, 750
- Non-competing groups, 107-111, 126; cause of international trade, 109, 110-111, 129-130
- Non-treaty rights and privileges of aliens, 375-376
- North, Dudley, and theory of money, 33
- Ohlin, Bertil, 8-9, 90, 130, 134 n., 137, 138, 152, 166 n., 684 n.
- Oldenburg, 317
- Oligopoly, 530
- Open door, 627, 630, 642
- Opportunity cost, 152-153
- Ottawa Agreements of 1932, 643 n., 666
- Overpopulation and colonies, 622, 635-637
- Overvaluation, 466, 476, 486, 490
- Page, T. W., 259 n., 396 n.
- Par of exchange, changes in, 716, 723 n.; mint, 68-69; purchasing power, 186-197
- Paranaguá, O., 334 n., 335 n.
- Patent laws, suggested revision of, 565
- Patent-licensing agreements, 534-536; in chemical industry, 535-536; nylon, 537 n.
- Payment, international, compared with domestic, 36-37; need for, 36
- Payments agreements, 497-499; compared with clearing agreements, 497, 498
- Pegging of exchange rates, 457
- Philippines Trade Act, 624 n.
- Physiocrats, 29-30
- Plants and plant products, sanitary regulation of imports of, 363-364
- Platt Amendment of 1901, 404
- Plummer, Alfred, 537 n.
- Pohle, 317
- Pole, Sir Felix J. C., 547
- Political aspects of cartels, 557-562; curbing military production, 559-561; national security, 562; preserving members' markets,

- Political aspects of cartels—(*Cont.*)  
561–562; supplying military information, 558–559
- Pollexfen, John, 19
- Popper, David H., 421 n.
- Population argument for colonies, 635–637
- Population growth, slowing-up of, and international trade, 737, 741–742
- Precious metals, and mercantilism, 18–23; as wealth, 18–22; only one form of wealth, 34
- Preferential duties, 249–251, 751; colonial, 625–627, 628, 629, 630, 633, 644
- Price, dumping, 518–521; monopoly, 516–518; theory of, 514–518
- Price control by cartels, 546–547
- Price discrimination, *see* Dumping
- Price levels, and specific duties, 254; changes in, 96; 101–102, 189, 190–191, 192–193, 194–197; national differences in, 187, 189
- Price-specie-flow mechanism, 90, 163–166
- Prices, equalization of, 145–147, 151; factor, 130–132, 135–136, 138, 140–141, 142, 145–147, 147 n., 176, 232; of cartels, 546–547; relative, 201–202
- Production costs, changes in, 160, 170, 176
- Productive factors, 130–132, 138–139; prices of, 130–132, 135–136, 138, 140–141, 142, 145–147; shifts in, 201
- Productivity of labor, 93, 98–99, 101–102, 103; and foreign loans, 678
- Prohibition of imports to combat dumping, 525–526
- Protection, 271–330, 426–431; against unfair competition, 359–360; and increasing vs. decreasing costs, 309–313; and industrial development of United States, 330–331; and industrial fluctuations, 318–321; and social diversification, 317–318; case for, 271–330; for military defense, 324–325; for
- Protection—(*Continued*)  
retaliation and bargaining, 307–309; growth of, 426–431; home market argument, 272–275; indirect, 351–368; infant-industry argument, 295–299; standard of living argument, 276–281; to accelerate rate of capital accumulation, 313–314; to assure supply of agricultural produce, 321–324; to avoid excessive industrialization and specialization, 317–324; to conserve natural resources, 292–293; to diminish unemployment, 300–307; to encourage migration of capital and labor, 314–317; to equalize burden of taxes, 290–292; to equalize costs of production, 288–292; to improve terms of trade, 293–294; to keep money at home, 287–288; to reduce real wages, 325–326; wages argument, 276–281; why it persists, 326–33
- Protective excise taxes, 368–371; compared with tariffs, 369–370; import, 368, 369; objectionable features of, 370–371; processing, 368–369
- Purchasing power, transfer of, 166, 168–169, 173–176, 186, 198, 203, 656, 658
- Purchasing-power parity theory, 186–197; calculation of, 188–190; evaluation of, 197; explained, 186–188; relation to exchange rates, 195; weaknesses of, 190–197
- Pyramiding of import duties, 229–231
- Quai d'Orsay and capital export, 669
- Quantity theory of money, David Hume, 33–34; Dudley North, 33; John Locke, 33
- Quotas, export, 541, 550
- Quotas, import, 415–416, 417–418, 431–450, 454–455  
allocation of, 445–450, 752  
and import licenses, 448  
bilateral, 449–450

- Quotas—(Continued)  
 compared, with import-licensing, 432; with tariff quota, 431-432  
 country, 446-448  
 defined, 431  
 effects of, upon prices, 437-442;  
 upon production, 442-445  
 extent of, after 1930, 432-435  
 global, 445-446  
 methods of allotting to importers, 448-449  
 preferential, 626-627  
 prospects of future use of, 455  
 tariff quotas, 439-442  
 use of, by France, 432-433  
 why used instead of tariffs, 435-437
- Quotas, tariff, 431-432, 439-442
- Rate of exchange, and prices of productive factors, 140-142; determination of, 65-67; effects of speculation on, 81-83; equilibrium rate, 188, 197-198, 200-201, 204; forward, 78-81; impact rate, 200; relationship of different rates in single market, 64-65; stable, under inconvertible paper currencies, 202-203; variations under gold standard, 67-71; variations under inconvertible paper currencies, 71-73
- Rate of foreign exchange, *see* Foreign exchange rates; Rate of exchange
- Raw materials, 540-543, 740  
 and colonies, 637-641, 646, 647; monopolistic exploitation of, 645  
 camphor, 541, 542  
 controls over, 540; objectives of, 541; success of, 541-543  
 natural scarcity of, 540  
 nitrates, 541, 542-543
- Real costs, 131-132
- Reciprocal demand, 94, 96-97, 126, 142, 143, 160-161, 181
- Reciprocal Trade Agreements Act, 248-249, 369, 370, 389, 408-424; agreement with Argentina, 419-420 n.; agreements signed, list of, 413 n.; amendment of
- Reciprocal Trade Agreements Act—(Continued)  
 1945, 424; and exchange control, 417, 418; and foreign-trade monopolies, 418; and import quotas, 415-416, 417-418; and United States policy of protection, 415-417; authority granted to President by, 411-412; background of, 409-411; criticisms of, 423-424; duty reductions under, 416-417, 423 n.; effects of, 420-424; escape clauses, 418-420; most-favored-nation clause in, 413-415; procedure under, 412-413; purpose of, 411
- Reciprocity, 379
- Reciprocity treaties, American, 401-404
- Reconstruction Finance Corporation, 671
- Reduction of import duties, 335
- Reexport trade, encouragement of, 332-333, 335, 339-340, 342, 345, 347; mercantilist policies toward, 25
- Registered marks, 470, 471
- Registry laws, 590
- Rent and costs, 125, 126
- Reparations, 163, 195-196, 429-430, 729; German, 163, 195-196; transfer difficulty, 163, 195-196, 429-430
- Reserves, bank, 164, 165, 167
- Restriction-schemes, raw material, 540-543, 633, 641
- Restrictions, trade, 422, 426-431, 481; and clearing agreements, 501-502; and colonies, 645; and gold standard, 703; and Reciprocal Trade Agreements, 422; elimination of, 727, 728, 729; of supply by cartels, 550-553, 559-561; quantitative, 748-749
- Ricardo, David, adjustment mechanism, 163; theory of exchange, 91 n., 91-92, 107
- Risk of exchange, 40, 199; avoidance of, 40, 707-708
- Roberts, George B., 82

- Robertson, D. H., 697 n., 737 n.  
 Roca-Runciman Agreement, 498-499  
 Rousseau, Jean Jacques, and social contract, 29  
 Royal Institute of International Affairs, 632 n., 646, 647, 673 n., 737 n.  
 Russian policy in southeastern Europe, 754 n.
- Safeguarding of Industries Act, 324, 426  
 Safety and welfare legislation in shipping, 592-593  
 Sanctions, economic, 638  
 Sanitary regulation of imports, and Reciprocal Trade Agreements, 419; of animals and animal products, 362-363; of plants and plant products, 363-364  
 Sayre, Francis B., 413 n.  
 Scarce currencies and International Monetary Fund, 721  
 Schüller, Richard, 314  
 Security, 748  
 Self-sufficiency, national, 325, 503  
 Senate ratification of trade agreements, 423  
 Shaw, L. N., 82  
 Shipbuilding industry, 581-584, 597  
 Shipping Board, 600, 601, 602  
 Shipping conferences, 577  
 Shipping costs, 581, 582-583  
 Shipping policy, colonial, 628-629  
 Shipping services as sources of demand for and supply of foreign exchange, 51, 161, 572, 574  
 Short-term capital movements, 44, 54-56; and forward exchange, 77-83; disequilibrating, 55-56, 162-163, 430; equilibrating, 44, 54-55, 156-158, 161-162, 166-169, 170, 198, 203, 702 n.; flight of capital, 55-56; forms of, 56; reasons for, 54-55  
*See also* Capital movements  
 Silver, *see* Gold  
 Slavery Convention of 1926, 632  
 Smith, Adam, 231, 325, 503; advantages of specialization, 86-87, Smith, Adam—(*Continued*)  
 88; and the "invisible hand," 30-31; attitude toward mercantilism, 30-31; protection and defense, 325, 503  
 Smithies, Arthur, 687 n.  
 Social conditions of production, 149-151; risk of enterprise, 150; taxes, 150; trade union policy, 150  
 Southard, Frank A., Jr., 476 n.  
 Specialization, and trade, 1-3; sources of, 85-87  
 Specie points, 69-71  
 Specific duties, 254-255  
 Speculation, foreign exchange, 81-83, 196-197, 205  
 Stability, financial, 728-729; political, 728  
 Stable exchange rates, 69-71, 198, 202-203, 696, 697-699, 709-714, 717  
 Staley, Eugene, 12, 202 n., 740 n.  
 Standard of living, 735-736, 740-741, 759; and level of money wages, 106-107; in colonies, 633-634; means of raising, 735-736  
 "Standstill" agreements, 162, 470  
 State aid, miscellaneous aids to private shipping, 592-593; to colonial development, 630; to private shipping, 584-593  
 State-controlled economies, 743-744  
 State Department and capital export, 669-670  
 State regulation of foreign investment, 667-676  
 Sterling bloc, 207  
 Steuart, Sir James, 25  
 Stevenson Plan of rubber control, 542, 639  
 Subsidies, mail, 597-598, 599, 602, 603  
 shipbuilding, 590-591, 603-605, 607  
 shipping, 578, 579-580, 587-589, 603, 607; contract, 587-589; general navigation bounty, 589  
*See also* Bounties

- Subsidization of German exports, 472-473
- Supply prices, 134 n., 139, 139-141
- Surplus countries and International Monetary Fund, 724
- Tamagna, Frank M., 198 n.
- Tariff Act of 1890, 269, 405-406
- Tariff Act of 1894, 406
- Tariff Act of 1897, 406, 407
- Tariff Act of 1909, 246-247, 402, 406, 407, 408
- Tariff Act of 1913, 247, 258 n., 408
- Tariff Act of 1922, 254-255, 258 n., 269, 288-289, 358, 386, 406, 407, 408, 426
- Tariff Act of 1930, 251, 253, 255-256, 261, 269, 288-289, 340 n., 354, 358, 363, 369, 427; amendment in 1934, 409; improvement trade, 340 n.
- Tariff bargaining, 393-424; after World War I, 398; American experience with, before 1934, 400-408; before 1914, 396-398; concessional and penalty, 394-395; conciliatory and aggressive, 395-396; effects of, 396-398, 398-400; purposes of, 393-394
- Tariff classification and specialization, 256-261
- Tariff Commission, U.S., 250 n., 277, 359-360, 522 n., 617 n.
- Tariff systems, double-schedule, 245-249; general-and-conventional, 245-246; maximum-and-minimum, 246-247; merits and defects of the two forms, 247-249 forms of, 243-251 single-schedule, 244-245 triple-schedule, 249-251
- Tariffs, 215-239, 241-263, 749 and industrial development of United States, 330-331 and international combinations, 554-557 autonomous and conventional, 243-244 colonial, 624-628 double-schedule, 245-249; general-
- Tariffs—(Continued)  
and conventional, 245-246; maximum-and-minimum, 246-247; merits and defects of the two forms, 247-249 flexible provisions of U.S. acts, 288-289 form of Canadian, 249 "free list," 335 incidence of, 222-232 measurement of height of, 261-263 methods of mitigating, 332-350 nature and types of, 216-219 quotas preferred to, 435-437 reduction of, 729, 749-750 revenue and protective, 217-219 "scientific" principle of tariff-making, 289 single-schedule, 244-245 technical aspects of, 241 to combat dumping, 524-525 triple-schedule, 249-251 why they persist, 328-330 See also Protection
- Taussig, F. W., 90 n., 104, 110, 111, 112-113, 114, 129, 130, 150-151, 165-166, 224, 277, 282, 287 n., 289, 297-298, 573 n.
- Technology, aid to international trade, 11-13; restriction upon international trade, 13 n.
- Temporary admission, 339-341
- Terms of trade, 93-94, 97, 99, 125, 682-683; and decreasing costs, 120; and foreign lending, 682-683; and import duties, 125; and increasing costs, 116-117; and protection, 293-294; more than two countries, 123-124; numerous commodities, 121-122
- Territorial status of Alaska and Hawaii, 624 n.
- Tourists' expenditures as source of demand for and supply of foreign exchange, 51, 161
- Trade, early, 16-17; and industry as destroyers of mercantilism, 28-29; essential to division of labor, 1-3, 85 "Trade follows the flag," 641-644

- Trade acceptance, 39  
 Trade Agreements Committee, 412, 413  
 Trade barriers, reduction of, 748-751, 754  
 Trade-cycle dumping, 513 n.  
 Trade-cycle theory, 755  
 Trade promotion and the merchant marine, 576-580  
 Trade restrictions, 13-15; and economic security, 14-15; and war, 14-15  
 Transfer moratoria, *see* Moratoria  
 Transit and transshipment, exemption from duties of goods in, 345-346  
 Transit duties, 219-220  
 Transition period and the International Monetary Fund, 726-727  
 Transitional problems of world trade, 746-747  
 Transportation, and international trade, 11-12  
   costs, 105, 143-145, 160, 239; and domestic goods, 105  
 Treaties, commercial, 372-392  
   *See also* Commercial treaties  
 Trendlenburg, 257 n., 260  
 Triangular clearing, 43-44  
 Tri-Partite Currency Agreement, 283, 713-714, 715  
 Types of foreign-trade commodities and adjustment mechanism, 182-183  
  
 Undervaluation of currencies, 212  
 Unemployment, 745, 754-755; and tariff, 300-307  
 Unfair competition, and Reciprocal Trade Agreements, 419-420; in shipping, 579; protection against, 359-360  
 Unfavorable balance, of payments, 159; of trade, 23, 60-61  
 United Nations, 319, 609, 614, 760; San Francisco meeting of, 759  
 United Nations Relief and Rehabilitation Administration, 728, 746  
 United States, responsibility of, for world leadership, 758-759  
 United States Government lines, 598  
 "United States value," 358  
 Valorization, Brazilian coffee, 541  
 Valuation of imports, 252-253; arbitrary, 358; methods of, 357-358  
 Value, general equilibrium theory of, 134-136; in international trade, 137-143  
 Vested interests, 298, 327-328, 329  
 Viner, Jacob, 21, 22 n., 32, 104 n., 386-387, 507, 509, 525, 526, 527 n., 752 n., 754 n.  
 Visible items in balance of international payments, 50  
 Volume of international trade, and economic trends, 742; and foreign lending, 683-684; and modern techniques, 738-742; and political forces, 742; and Reciprocal Trade Agreements, 420-422  
  
 Wage policy, colonial, 632  
 Wägenfuhr, 530  
 Wages, and mercantilism, 25-26; comparison of, in six cities in United States, 7; in shipbuilding, 582 n.; international comparison of, 7  
 Wagner, A., 317, 318 n., 321-322  
 Wallace, Benjamin B., 414-415, 541  
 Wallace, Henry A., 415  
 War, causes of, 759-760; and colonies, 644-645; and industrialization, 14-15; and merchant marine, 573-575, 608-609; and trade, 742-743, 759-760; and trade restrictions, 14-15, 478, 503-504  
 War debts, 429-430, 728-729  
 War Shipping Administration, 606 n.  
 Webb-Pomerene export associations, 543-544; and antitrust laws, 543; experience of, 544  
 Weight-losing materials, 145  
 Welsh, Charles A., 551 n., 560  
 Whale, Barrett, 327-328  
 Wheatley, John, 187 n.  
 White, Harry D., 166 n., 657 n., 660, 680 n., 681, 682 n., 717 n.

- Whittlesey, C. R., 433 n., 683 n., 708 n.
- Williams, John H., 189 n., 194-196, 697 n., 703 n., 704, 706, 724 n.
- Wilson, Roland, 166 n.
- World Court, 391
- World economy, development and integration of, by international capital movements, 684-686
- World trading system, permanent foundations of, 747-756
- Wright, Quincy, 614 n.
- Yield on capital, 658-659, 691
- Young, Allyn A., 196-197
- Zeis, Paul M., 575 n., 577 n., 578 n., 595 n., 599 n.
- Zollverein, 220





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