V

Foreign Trade

IN the *laisser-faire* philosophy at its most extreme there is no place for a special chapter on foreign trade. No significant difference between domestic and foreign trade is recognised. Trade between London and Paris or New York does not differ from trade between Cardiff and Glasgow, and needs no special treatment. Foreign trade is self-regulating, and raises no problems that domestic trade does not raise. There may be people who still believe all this, but they are now very rare.

PROTECTION

The first breach in this position is made when it is accepted that, whatever may be the case for or against a general regulation of trade, affecting all imports and exports, there may be a case for deciding that certain particular industries should be maintained at home, to the exclusion or curtailment of imports. Two important classes are generally admitted.

First there are defence industries. In the past much of the case for protecting agriculture has rested on this ground. More recently it has become plain that the countries that win wars are not those that are self-sufficient in food, or that have a sturdy peasantry, but rather those that are highly industrialised, and the emphasis is changing now to steel, and chemicals and some branches of engineering.

The second exception recognises the fact that an industry is not at its strongest until it has attained a certain size and experience. Hence, if protection were ruled out, often the country that started an industry would be able, by competing abroad, to prevent other countries from following in its footsteps, and might succeed in making substantial profits at their expense, although, if once their industries were able to get past their teething troubles, they would be quite as efficient as that

of the country first in the field. This infant industry argument is now seen to have very wide implications. For what is true of one industry is even more true of industrialisation as a whole. Countries predominantly agricultural are at a disadvantage when they start to industrialise, in competition with the older industrial countries. But, given a stage of protection, they may in due course be perfectly capable of holding their own.

Both these cases have their parallel on the side of exports. The defence argument is used frequently to justify banning certain exports, or exports of certain goods to certain countries, e.g. from the U.S.A. to the U.S.S.R. And there are many examples in history of countries trying to keep at home certain inventions or types of machinery, in order to prevent competitors from catching up.

Another restriction now widely accepted, is control over the export of capital. This is a necessary corollary of planning for equality, since, in the absence of such control, capitalists can evade equalitarian measures by exporting their capital. To prevent any capital whatsoever from being exported would be a formidable task, but the larger movements can be controlled without excessive restrictions.

BALANCING PAYMENTS

These arguments for particular prohibitions can be accepted without damaging the general case. If foreign trade is to be left to regulate itself (apart from these exceptions to which no further reference will be made), then imports and exports must balance, when invisible items and long term capital movements are included. For, if imports and exports do not balance, then the net result of foreign trade will be either inflationary, if exports are in surplus, or deflationary if imports exceed exports. The essence of the *laisser-faire* case is that this balance is secured automatically. If this is so, it follows that attempts to regulate trade are mischievous. Each person should buy in the cheapest market, whether at home or abroad; if this causes imports to rise, exports will rise also. Domestic employment cannot be increased by reducing imports, because this will reduce exports to the same extent. And the national income cannot be increased

by shutting out imports, because this will merely cause resources to be diverted to produce for home consumption away from the more profitable export markets that they were previously serving. If it were true that a mechanism existed which automatically linked imports and exports, these conclusions would be beyond challenge. Foreign trade could be left to look after itself, and the state need not plan it.

The extreme *laisser-faire* position sees such a mechanism in the foreign exchange market, with freely fluctuating rates of exchange. Here exports and imports (including invisible items) are kept equal by the currency being driven to whatever level is needed to keep them equal. This follows because importers are selling the currency to get foreign currencies to pay for what they have bought, and exporters are selling foreign currencies and buying their own. Since the price will move to whatever level equates demand and supply, it will automatically equate imports and exports. But since demand and supply change, not only from day to day but even from hour to hour, the result of this free market is a rate that fluctuates constantly. It is generally agreed that these fluctuations are undesirable, and that it is more convenient and better for trade to stabilise rates of exchange.

To fix the rate of exchange, however, is to make a sharp break with *laisser-faire*, for the state is at once dragged into the picture. The rate can be stabilised only if someone agrees always to buy and sell at the stipulated rate, and that someone has to be the government or its agent.

Once the rate is fixed, some other mechanism must be found to keep imports and exports in equilibrium. The modified *laisser-faire* position is still that the adjustment can be procured automatically. If imports are too large, money leaves the country. Prices therefore fall in the country with an import surplus, and rise in those countries that have a corresponding export surplus. The fall of prices makes home produced goods cheaper than imports, and so reduces imports; it also cheapens exports, and so increases them. So long as imports exceed exports, on this view, prices will continue to fall through money leaving the country to pay for the import surplus, and so imports will be checked and exports increased until they once more balance. Similarly if exports are too large, money comes

into the country, prices rise, imports become relatively cheaper and larger, exports become relatively dearer and smaller, and so the export surplus is whittled away. This process is supposed to be automatic, but in order to make sure that it should work, governments are enjoined to reinforce it. When money is coming in, they should multiply it, so that prices at home do not fail to rise; and when it is flowing out they should give an extra turn to the tap reducing the circulation of money so that prices should not succeed in resisting the fall. Thus instead of the domestic price level being independent, and the foreign exchange rate fluctuating in order to effect adjustments, the foreign rate is stabilised, and the domestic price level is required to adjust to the changing conditions of foreign trade.

The trouble, of course, is that the domestic price level refuses to behave as this theory demands. When there is an import surplus prices fall a little, but not much. The adjustment that should be effected through prices is then effected through employment. The deficiency of effective demand due to the import surplus causes employment and the national income to contract by a multiple of the surplus. Exports increase very little, because prices are not falling, and the bulk of the adjustment is borne by the domestic income contracting so much that imports are eventually reduced to equality with exports. The real alternative to a changing exchange rate is not a changing domestic price level, but a changing level of employment and of national income.

Moreover, it is not only the domestic national income that contracts by the multiple of a deficit; it is also the volume of international trade. If one country has a large export surplus, paralleled by an import surplus in the other countries, this surplus could be eliminated if each of the deficit countries deliberately cut its imports from the surplus country, and there would be no multiplier effects. But if such deliberate and discriminatory planning is forbidden, each deficit country will reduce its imports all round as income contracts, and the deficit countries will reduce their trade with each other, as well as with the surplus country, thus effecting a much greater contraction of total trade than is necessary.

The moral of this is that it is indeed true that foreign trade is self-regulating, and will look after itself without interference;

but it is also true that the results of this self-regulation may be disastrous.

If the rate of exchange is to be kept stable, governments must have the right to control imports directly, so as to keep them in line with exports without having to suffer the deflations and inflations that automatic regulation would involve. They must also have the right to discriminate against surplus countries. The choice is between a free exchange rate and planned foreign trade.

It must, however, be noted at once that this planning must follow internationally agreed rules, or we shall all be worse off than if there were no planning. Thus a government is justified in controlling imports if it has an adverse balance; but if countries with an export surplus proceed to cut imports the best efforts of deficit countries to achieve balance will be frustrated. Similarly, a deficit country is entitled to try to redress its position by depreciating its exchange rate, but it cannot succeed in doing this if the surplus countries insist on depreciating *pari passu*. International trade and exchange policy must be governed by rules, as much in the interest of the weak as in the interest of the strong. That is why the U.K., temporarily a weak country, has been right in sponsoring the Bretton Woods monetary agreement, and the International Trade Charter. Neither of these documents is perfect; but they do embody rules designed to restrict the arbitrary actions of the strong. Given that there are international rules to preserve order, the choice can be exercised between varying exchange rates and applying more direct controls.

Using the rate of exchange to equilibrate export and imports does not necessarily involve day to day fluctuations. The rate can be set at the level which is expected to be adequate over the average of a period ahead, while allowing day to day fluctuations in demand and supply to be met from day to day changes in the working stock of gold and foreign exchange reserves. This was the purpose of the Exchange Equalisation system operated during the 'thirties; the rate could be altered to meet a fundamental disequilibrium, but was stabilised in face of short term changes that would cancel out.

This technique is most appropriate to a small country whose imports and exports are competitive. In such a case the prices

that the country receives for its exports or pays for its imports are outside its control, and its terms of trade are not affected by changes in the foreign exchange rate. If its currency depreciates, the prices of its imports and its exports rise correspondingly in terms of local currency, while remaining unchanged in terms of foreign currency. Production for export is thus made more profitable, and attracts additional resources; and since the world market is large relatively to the country's exports, additional exports can easily be sold. At the same time the rise in the price of imports checks demand. Exchange depreciation thus automatically reduces imports and increases exports, and will secure equilibrium if pushed far enough.

Even in this most favourable case, however, there may be snags. If the imports are essential commodities, even a large increase in price may have little effect on demand; then the whole burden of adjustment falls on exports, and the ease with which it is borne depends on how easily the flow of resources to exports responds to additional prices for exports. If this flow also is slow, the rate of exchange may be forced down very low indeed. Moreover, as import prices rise, the cost of living rises, and workers demand and receive higher wages. This can frustrate the whole purpose of exchange depreciation, which works by reducing the domestic price level relatively to world prices. If every time the rate of exchange falls, wages and the domestic price level rise correspondingly, exchange depreciation cannot equilibrate imports and exports. Even a small country, therefore, may find itself, when the exchange rate falls, trying to stabilise the internal price level by subsidising imports; and since this puts the whole burden of adjustment upon exports, it may have to take vigorous measures to increase exports directly. And it may end, if resources are slow to move, by limiting imports by licence, and stimulating exports by direction.

The larger the country the greater the snags. Exchange depreciation by a large country almost inevitably causes the terms of trade to deteriorate. Prices of imports fall somewhat in terms of foreign currency if it is a large consumer, but prices of exports also fall, and if it is a manufacturing country whose exporters base quotations on domestic costs, export prices in foreign currency may fall by the whole amount of the depreciation. Export prices then fail to rise in domestic currency, and

resources are not attracted to exports. At the same time the fall of prices in foreign currency stimulates foreign demand, but unless this stimulus is substantial (i.e. unless the elasticity of foreign demand exceeds unity) the country will actually get less foreign exchange for more exports. In the long run foreign demand is elastic; buyers will change over to the sellers with lowest prices, but in the short run foreign demand is much less elastic, and exchange depreciation may worsen the position of a deficit country. The experience of the United Kingdom in the last three years is a grim example of this. We have had an adverse balance, but foreign demand has been very inelastic, and if we had depreciated the pound we would have lost heavily. On the contrary, we would have done better if we had put the pound higher. This, for example, has been the secret of Belgian prosperity. In the year June 1946 to June 1947, according to calculations made by the Economic Commission for Europe, the Belgian index of commodities available for home use (basis 1938) stood at 123, while the U.K. index was only at 95. But this was not because Belgium had recovered faster than Britain, for Belgian production was only at 94 while British production was at 108. The difference was due to the fact that Belgium was importing more than pre-war and exporting less (imports 120, exports 71 in the first nine months of 1947) while Britain was importing less and exporting more (77, 106). How did Belgium manage to finance a higher level of imports from a lower level of exports? Partly from windfall payments on invisible account. But very largely, also, by selling at high prices. In terms of dollars the Belgian export price index was at 261, while the British was at 182. 71 per cent quantum sold at 261 per cent price yields 185 per cent revenue, which is nearly as much as 106 per cent quantum sold at 182 per cent price, yielding 193 per cent revenue. The Belgians earned as much in foreign exchange while keeping their goods at home to add to home consumption instead of exporting them. British visitors to Belgium thought that the obvious signs of prosperity there were due to a greater recovery, and wondered whether this was not due to greater *laisser-faire*; but it was, in fact, due mainly to better planning of the foreign exchange rate. It is now clear that we would have gained by putting the pound higher in 1945; if its dollar rate had been 25 per cent higher we should have saved some

£600 million pounds or so of gold and foreign exchange. No doubt we could not hold the pound for ever at that level, because as industry elsewhere expands demand will become more elastic; over-valuation in the nineteen twenties, for example, proved very costly. But all this only reinforces the point that equilibrium cannot always be attained by following simple rules of exchange manipulation.

The major snag is the slowness with which resources move. If adjustment were perfect, the rate of exchange would always achieve equilibrium As it fell, and prices of imports rose in domestic currency, domestic production of substitutes would expand rapidly, and imports would fall substantially. As export prices rose, if the terms of trade were unaffected, or as foreign demand increased and raised export prices, resources would move rapidly into export industries. Thus, whether by checking imports or by expanding exports or both, exchange depreciation would do the trick, and do it rapidly. Unfortunately the movement of resources is very slow. Once we have reached an equilibrium position we can hope to keep it without foreign trade controls if there are no major changes in demand or supply. But when we are as far from equilibrium as most countries of Europe are today, the licensing of imports and the direction of exports are essential.

A shortage of foreign currency is of all shortages the most ruinous to the attempt to plan solely by inducement, not only because it is itself difficult to eliminate without more rigid controls, but also because controls applied to imports and exports work their way through to bind almost the whole economy. It is therefore all the more desirable to eliminate this shortage as rapidly as possible, and even with the most vigorous forms of control. (That is to say, it is desirable to eliminate an import surplus if it is an unwanted surplus, which will be the case to the extent to which it is not covered by long term borrowing from abroad; a surplus financed by long term borrowing does not give rise to a shortage of foreign exchange.)

The most common cause of an import surplus in Europe today is the fact that most countries are investing more than their peoples are willing to save. The difference is paid by foreigners (in so far as it does not come out of foreign exchange and gold reserves), and takes the form either of excessive

imports or of too low a level of exports. It can be eliminated by importing less or exporting more, and both of these can be enforced by physical controls, but in that case the money that would otherwise have been spent either on imports or on domestic goods now exported will most of it chase after the reduced supply of goods at home and increase the inflationary pressures. The first step towards equilibrium is therefore to mop up this money; that is to say. to increase domestic savings or to increase taxation, or if neither of these can be done, to cut investment. Monetary control can go most of the way to closing the foreign gap, and it is this that most European countries need most, even more than exchange control. But monetary control may not go all the way to eliminate the shortage of foreign currency. For even when there is no inflation, indeed even if there is considerable unemployment, it may nevertheless be the case that domestic production of the types of exports that foreign buyers like is small, and that relatively to what can be exported imports are too high. Control of imports is then necessary, and also measures to increase exports, such as the fixing of compulsory export quotas, and drastic measures to man up export industries. A country like the U.K., which has at the same time a high propensity to import, a severe maldistribution of labour, and a high degree of immobility of resources is bound to be rigidly controlled for some time. The need for these controls depends not only on the removal of inflation but also on the speed with which productive resources can be reallocated. It is immobility which principally makes physical controls necessary, and we shall revert to this subject in the next chapter.

THE TRADE CYCLE

Unfortunately, the difficulties do not end here. If foreign demand were relatively stable, changing, but only slowly, licensing and direction could be used to correct a fundamental maladjustment, and then abandoned; equilibrium thereafter being maintained solely by occasional adjustments of the rate of exchange. But foreign trade shows no such stability. It fluctuates violently both in price and in quantity, in response to the trade cycle. For many years this cycle has been dominated by

the U.S.A., and it is safe to say that the fluctuations of world trade depend largely on domestic events in the U.S.A.

The first reaction to this unpleasant situation is naturally to try to reduce dependence on the U.S.A. Thus in these days schemes for starting trading clubs excluding the U.S.A. have become very popular, especially imperial preference, customs unions, and bulk trading contracts between governments. Each of these has serious technical limitations which make it much less effective than is supposed, but each has some advantages. It is very desirable that production should be increased substantially outside the United States, even apart from any question of trade fluctuations, so that the export surplus of the U.S.A. may be eliminated; and so long as that surplus persists, discrimination against the U.S.A. is also a desirable alternative to a general deflation of international trade. This case for discrimination is reinforced by the instability of American trade; until such time as the U.S.A. effectively pursues a full employment policy, nations that are planning for stable employment are justified in seeking to reduce their relations with the U.S.A.

But all this is not likely to get very far. In the first place, the United States is the world's biggest importer of raw materials and one of the biggest importers of food. All primary producers are interested in and dependent upon this valuable market, and they transmit this dependence to the manufacturing countries who sell to them, and who would thus be affected by American fluctuations even if they themselves had no direct trade with the U.S.A. And, secondly, most countries in the world look to the U.S.A. for loans. Countries dependent on the U.S.A. either for trade or for loans cannot practise more discrimination against the U.S.A. than that country is willing to allow. The U.S.A. has already indicated how much discrimination against itself it will tolerate; this is stated in the Bretton Woods agreement, in the International Trade Charter, and in the Marshall agreements. We must use it such as it is, and we may ask for more; but to try to get more adopted in defiance of the U.S.A. is a waste of time. The other countries concerned are in no position to defy the United States. What we are most entitled to demand is that the rules of Bretton Woods be altered in two ways; first, to make it easier to declare a currency to be ' scarce '

when it is in fact scarce, and secondly, to add the power to require a country which has a persistent export surplus to appreciate the value of its currency. The latter is the easiest form of discrimination to work, and the most likely to be accepted.

We must resign ourselves to cyclical fluctuations in international trade until such time as the U.S.A. is converted to planning for stability. This means that the prices of imports, measured in dollars, will rise and fall at regular intervals, and that the domestic price level will fluctuate similarly unless special steps are taken to stabilise it.

If the foreign exchange rate is kept stable through the upswing of the cycle the cost of living will rise, and wages and the domestic price level will also be dragged upwards. Then, when the slump comes, import prices will fall. If it is then decided to keep wages stable and not to reduce them as the cost of living falls, then export prices will be high in relation to foreign prices which have fallen, and unemployment in the export trades will be severe. This might be avoided by depreciating the foreign exchange rate when the downswing begins But this will mean that the domestic price level rises each time there is a boom abroad, but never falls; and the foreign exchange rate falls each time there is a slump, and never rises. There will thus be a cumulative inflation of domestic prices, and a cumulative depreciation of the pound. This is most undesirable. If wages and the domestic price level are to rise when foreign prices rises, then they must also fall when foreign prices fall.

Domestic prices could be stabilised by subsidising imports in the boom and taxing them in the slump, since this would keep the cost of living steady. But what then happens to exports? It is desirable that British export prices should rise when foreign prices rise and fall when foreign prices fall. Otherwise we are deliberately turning the terms of trade against ourselves in the boom, when we sell the largest quantities with the least effective competition, and the fact that they will turn in our favour in the slump, when we sell smaller quantities in acute competition, is no compensation for this. This is the policy we have been pursuing in the past three years—subsidising imports to keep wages and prices steady, and thus keeping down the prices of exports, and deliberately turning the terms of trade against ourselves. This is a foolish policy, which has already cost us

several hundred million pounds of foreign reserves. If we stabilise the rate of exchange, and stabilise wages and the cost of living by subsidy, then we must raise export prices by imposing export taxes. Import subsidies and export taxes together can stabilise the domestic price level without causing adverse terms of trade, but one without the other is too costly.

The alternative way to stabilise internal prices, without the bother of paying subsidies and collecting taxes, is to destabilise the foreign exchange rate. On this plan the rate appreciates during the boom and depreciates during the slump. The simplest way to achieve this is to link the rate to an American index of wholesale prices, or a U.N.O. index of foreign trade prices. This has obvious disadvantages, but it would be much better than the policy we have pursued in the last three years.

In sum, the existence of the trade cycle presents grave difficulties in foreign trade, to which there is no perfect solution. There are three choices; to let wages and prices rise in the upswing, *on condition that they fall in the downswing* ; or, to stabilise wages and prices by subsidising imports in the upswing, *on condition that exports are correspondingly taxed* ; or to appreciate the pound in the upswing, and depreciate in the downswing. The first of these would be resisted by the workers, and the second by the merchant community. This leaves the third as the most politically acceptable choice, though not necessarily the best economically. Whichever we choose, none is so bad as the policy which we are now actually pursuing at such great loss to the nation as a whole.

CONCLUSION

The conclusions of this chapter may be summarised as follows:

(1) Some types of foreign transaction need regulation, without prejudice to the general issue; examples are controls in the interest of defence or of infant industries, and restrictions on refugee capital.

(2) General control of trade is unnecessary if imports and exports can be kept equal without it, and without grave inconvenience; but this is seldom the case.

(3) An absolutely free rate of exchange is a nuisance; and an absolutely fixed rate of exchange is incompatible with domestic stability in countries where costs are inflexible.

(4) State planning of foreign trade would be ineffective and chaotic in the absence of international agreements prescribing the rules that planning must follow.

(5) In the long run imports and exports can be equilibrated by fixing an appropriate rate of exchange, subject to alteration as conditions change; but in the short run further controls are required, if the mobility of resources is low.

(6) Special measures to stimulate production in and trade between countries other than the U.S.A. are desirable so long as the U.S.A. has an export surplus (not covered by loans) and so long as the U.S.A. does not plan for stable employment and trade. [illegible]

(7) While trade cycles last we must either let the domestic price level fluctuate with foreign prices, or let the foreign exchange rate fluctuate. We must not stabilise both domestic and external rates unless we adopt both import subsidies and export taxes.