INTERNATIONAL TRADE AND NATIONAL PROSPERITY

Charles P. Kindleberger

In writing about foreign trade over the years, I have churned out a fairly complex set of ideas dealing with the relationships between trade and growth. More exports can either stimulate or retard growth; more imports, too, can either stimulate or retard growth. A reduction in exports or imports may also spur or slow the growth of an economy. If we start from the other end, more growth may limit or increase exports, and equally may lead to a gain or decline in imports.[1] A standard joke in my classes, repeated year after year to what I trust is the delight of successive generations of students, is that the answer to every question in economics is "it depends." The answer to the immediately following question, which you can supply, is usually "on the elasticities." In the present case, however, whether more or fewer exports or imports speed or slow growth depends on something rather different, namely the nature of the ongoing growth.

Keynesian versus Schumpeterian Growth

Some years ago, Henry Wallich, in his academic incarnation, differentiated between Keynesian and Schumpeterian growth.[2] Keynesian growth assumes a given state of the arts, as it was called in

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[1]See Charles P. Kindleberger, "Foreign Trade and Economic Growth, Lessons from Britain and France, 1850–1913, *Economic History Review* 14 (December 1961): 285–305; idem, "Foreign Trade and Growth: Lessons from British Experience since 1913," *Lloyds Bank Review* 65 (July 1962): 16–28; and idem, *Foreign Trade and the National Economy* (New Haven: Yale University Press, 1962), chaps. 11–12.

[2]Henry Wallich, *The Monetary Problems of an Export Economy* (Cambridge, Mass.: Harvard University Press, 1950).

F. W. Taussig's day, or fixed technology. More exports stimulated growth through the foreign-trade multiplier, as increased incomes in the export sector resulted in increased spending throughout the economy; and increased growth from domestic spending spilled over into more imports. More exports typically improved the balance of payments; increased domestic spending worsened it, even though the effect on national prosperity of an equal dose of export or domestic spending would be the same. An increase in imports arising from new industries abroad hurts income and prosperity as domestic output is displaced and jobs are lost.

In a Schumpeterian model, on the other hand, growth comes from innovation that tends to be export-increasing and import-decreasing. Innovation in export lines—new products or new ways of producing old products—stimulates foreign trade, while innovation leading to import-substitution—generally new ways of producing existing products—reduces it. In either case the balance of payments is improved.

Perhaps the most interesting cases involving the Schumpeterian model are those in which more exports hurt national prosperity and more imports enhance it. Great Britain provides a telling example of the first. I have argued that in turning its export trade away from the competitive markets of Europe and the United States in the last third of the 19th century, and concentrating on exporting more traditional goods—cotton textiles, ships, steel rails, galvanized iron sheets and the like—to the Empire, Britain missed out on the electrical, automotive, and chemical industries beginning to burgeon on the Continent and in the United States.[3] More of the same was a recipe for slowdown in a stage of economic menopause or climacteric, achieving Keynesian perhaps but evading Schumpeterian growth. In France, on the other hand, more imports under the Cobden-Chevalier treaty of commerce of 1860 stimulated the conversion of the iron industry from charcoal to coal and accelerated technical catch-up in cotton textiles.[4] Unfortunately, nature abhors controlled experiments, and credit for the economic growth enjoyed by France in the two decades before the Franco-Prussian War of 1870 must be shared with the spread of the railroad system in the 1850s and 1860s, the stimulus to public works from the innovation of industrial banking by the Crédit Mobilier and its imitators, and the discoveries of gold in California and Australia.

[3]See Kindleberger, "Foreign Trade and Economic Growth."

[4]Arthur L. Dunham, *The Anglo-French Treaty of Commerce of 1860 and the Progress of the Industrial Revolution in France* (Ann Arbor: University of Michigan Press, 1930).

A peculiar case resulting from the same treaty can be found in Coventry, England. There, cheap imports of French silk ribbon killed a struggling import-competing industry, adding to existing unemployment in the watch industry, caused by earlier French and Swiss innovations unmatched in the backward English trade. In the short run, this was painful; in the long run, it established the basis for economic success. Skilled workers from the watch industry and abundant, relatively unskilled labor from the silk-ribbon industry made Coventry a suitable place in which to start the manufacture of bicycles, a dynamic industry in the 1880s. It was this transformation that by the turn of the century furnished the nucleus for the British automobile industry.[5]

The debate in Britain two decades ago over whether to join the Common Market centered on some important questions. Would competition from imports set back weak industries (a Keynesian model)? Would access to markets on the Continent energize the strong? And most important, would increased imports from the Continent stimulate lagging British industries to cut costs and learn to grow, or merely lead to their demise (a Schumpeterian model)? My colleague, Dean Abraham Siegel, is fond of recounting a visit to the Foreign Office in London at about this time, where he met an economic official opposed to entry who said, "Not every kick in the pants galvanizes, you know. Some just hurt."

How does one learn whether an economy is poised on the edge of Schumpeterian growth or has relapsed—I think it fair to call it a relapse—into Keynesian growth in which the drive to innovate has flagged? Most economies have both: the new industries of high technology and the old, sometimes characterized by smokestacks, in which technical change has slowed to a walk. What the net effect of the two is may well differ, depending upon whether one uses employment or value-added as weights.

Olson's Hypothesis: The Role of Special Interests

A hint as to the functioning of the total economy was recently furnished by Mancur Olson, who examines the extent to which an economy is beset by interest groups or "distributional coalitions."[6] These groups organize to use political instead of economic power to raise prices and increase their real incomes, without adding to their

[5]John Prest, *The Industrial Revolution in Coventry* (London: Oxford University Press, 1960).

[6]Mancur Olson, *Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

overall productivity—a point also made by Lester Thurow.[7] Olson believes that the longer a society continues with unchanged boundaries and without the shock of revolution or defeat in war, the more encrusted it becomes with these coalitions and the more incapable of responding to economic challenges at home and abroad. Political agendas become crowded, slowing down decision making. Vested interests block one another, impeding action. He asserts that the miraculous growth of Germany and Japan after World War II is ascribable in considerable measure to the fact that the dictatorships of the 1930s, plus defeat in war and occupation by the victors, dissolved the interests that could block advance. Instead of individuals and firms relying on their cartel, lobby, union, or other organization to advance their interests, it was necessary to work hard alone. Young countries, relatively unhampered by distributional coalitions, are readier to innovate, to reallocate resources from one industry to another, to meet competition from abroad with cost reduction, and are less prone to inflation, and to reach for the remedy of protectionism.

The Free-Trade Movement in Britain and Northern Europe

Let me acknowledge immediately that free trade, like tariff protection, has cogently been characterized as a design of particular interests, as much as or more than the result of enlightened thought and economic teaching. It is well known that the Anti-Corn Law League in Great Britain represented the cotton manufacturers of Manchester. They opposed tariffs and wanted cheap imports of grain to hold down wages and the cost of living and to slow down industrialization on the Continent by encouraging farming there. They hoped that by importing more grain from Europe, they could sell Europe more cloth. A number of historians call this "free-trade imperialism."[8] Friedrich List, the German protectionist of the 19th century, characterized evangelical free trade as the tactic of the climber who gets to the top of the wall and kicks away the ladder to prevent others from following him up.[9]

If one takes an especially Spenglerian view of tariff history, he can see two broad cycles toward and away from free trade: the first led by Britain, which sponsored the Industrial Revolution; the second

[7]Lester Thurow, *The Zero-Sum Society* (New York: Basic Books, 1981).

[8]John Gallagher and Ronald Robinson, "The Imperialism of Free Trade," *Economic History Review* 6 (1953): 1–15.

[9]See Friedrich List, *The National System of Political Economy* (1842), trans. Sampson S. Lloyd (London: Longmans, Green, and Co., 1904).

by the United States after it had emerged strengthened from World Wars I and II. In both cases, the country had been protectionist in the century before and had also benefited from the protection afforded by a major war.

The free-trade movement in Britain was not fundamentally a response to the arguments of Adam Smith. The manufacturing classes first won the right to vote in the Reform Bill of 1832, then undertook "fiscal reform" that simplified thousands of duties, repealed the Corn Laws, and moved to free trade generally. The rest of Europe, but not the United States, followed suit, moved partly by such export interests as the Junkers with their large grain farms, partly by ideology, and partly by extraneous considerations of foreign policy. Napoleon III, for instance, agreed to the Anglo-French Commercial Treaty of 1860 over the protests of all the interest groups in France except the relatively weak export groups—Bordeaux in wine, Lyons in silk, and Paris in jewelry and similar luxuries.

The free-trade movement produced its most drastic changes in northern Europe. Tariff reduction went well beyond the confines of repeal of the Corn Laws to abrogation of the Navigation Acts of the 17th century, removal of the preferential timber duties that favored Canada over Scandinavia and the United States, and ultimately brought protection down to the level of tariffs for revenue only—that is, on products such as sugar, tobacco, wine, brandy, and the like, not produced in the British Isles. Trade liberalization set off a surge of exports from Sweden to Great Britain—largely oats for the horses of London,[10] plus timber and high-grade iron[11]—and led to a large increase in Norwegian shipping.[12] It also prepared Denmark (and the Netherlands) for the rise in exports of animal products—butter, cheese, bacon, eggs, and the like—for which the demand in Britain increased with rapidly rising income.[13] In world economic history there is no better illustration of export-led growth.

This free-trade movement lasted from about 1840 to 1875. But Great Britain clung to free trade until after World War I, an example

[10]Gunnar Fridlizius, *Swedish Corn Exports in the Free Trade Era: Patterns in the Oats Trade, 1850–1880* (Lund: G. W. K. Gleerup, 1957).

[11]Arthur G. Montgomery, *The Rise of Modern Industry in Sweden* (London: P. S. King, 1939); Lars Jörberg, "Structural Change and Economic Growth in Nineteenth-Century Sweden," in *Sweden's Development from Poverty to Affluence, 1750–1970,"* ed. Steven Koblik (Minneapolis: University of Minnesota Press, 1975).

[12]Victor D. Norman, "Trade Liberalization and Industrial Growth: The Impact of British Trade Liberalization in the 1840s on Industrialization in the Scandinavian Countries," unpublished term paper, Massachusetts Institute of Technology, 17 December 1970.

[13]Einar Jensen, *Danish Agriculture: Its Economic Development* (Copenhagen: Munksgaard, 1937), chap. 12.

in some views of cultural lag or conditioned reflex that dominated the vested interests. The same sort of lag will be encountered again in U.S. tariff history. Germany, France, Italy, and Sweden adopted tariffs largely, the guess may be hazarded, because Britain had lost its leadership role and was turning away from Europe politically and economically, and beginning to close itself in the Empire. British pressure for free trade, intense from the 1840s to 1870s on the Continent, was less and less felt.[14]

In this view, free trade, like world peace and world monetary stability, is a public good that needs an enforcer to flourish. The fallacy of composition—that the whole is less than the sum of the parts when the parts interact, and even a negative good or a bad—means that any one country may gain (in its terms of trade, perhaps in the balance of payments, or in avoiding the necessity to transfer politically powerful resources out of an existing industry) from imposing a tariff; but when all countries restrict trade, international trade declines and all lose. Unless there is an enforcer of free trade—some country that wants free trade for itself and twists arms to get others to follow suit—the fact that each country may gain separately from a tariff, or may be forced to adopt protection by dominant interests, produces a negative result overall.

The Free-Trade Movement in America

When Britain no longer provided the leadership, example, and arm-twisting to keep Europe in line on free trade, the United States took over in the 20th century. In this second of tariff cycles, the timing of the start is uncertain and may be said to have begun with the Reciprocal Trade Agreement Act of 1934, or more certainly in 1941 with the Atlantic Charter, Article 7 of the Lend-Lease Agreements; and postwar with the International Trade Organization, the General Agreement on Tariffs and Trade, and the bilateral agreements under the European Recovery (Marshall) Plan. It is a matter of some historical interest that Great Britain tried rather feebly after the Napoleonic Wars to extract commitments of free trade, i.e. free entry of British manufactures, out of the allies which it had subsidized during the wars, but to little avail.[15] The pressure of the United States

[14]Lucy Brown, *The Board of Trade and the Free-Trade Movement, 1830–1842* (Oxford: Clarendon Press, 1958).

[15]John M. Sherwig, *Guineas and Gunpowder: British Foreign Aid in the Wars with France, 1793–1815* (Cambridge, Mass.: Harvard University Press, 1969), pp. 311–13, 330.

on its allies and defeated enemies was far greater, although in the case of Japan less than completely successful.

As in the case of Britain, U.S. leadership in the free-trade movement can be regarded either as a national effort to produce a world public good—wide markets—or as the achievement of the selfish interest of the abundant factor of production that wanted imports in order better to export. It is perhaps significant in this connection that the United States always insisted that tariff reductions should be reciprocal. In Great Britain, which perhaps believed more fervidly in Hume's law that imports beget exports, unilateral tariff reduction was approved and those who worked for reciprocity were regarded as less than faithful. In the 19th century when the South, with a strong interest in cotton, worked for free trade—on the whole unsuccessfully—U.S. manufacturing was import-competing and protectionist. With the rise of large-scale manufacturing to world dominance in World War I, big American business was on the whole slow to recognize that its interest lay in low tariffs and free trade. For example, Senator Robert Taft from Cincinnati, which exported machine tools throughout the world, remained a staunch protectionist through cultural lag, much as Senator Walter George of Georgia remained a free-trader long after cotton growing had moved to Texas and California and his state was knee-deep in textile plants that would benefit from protection. The manufacturing sector in the United States gradually split on the tariff question: Modern, large-scale industry, multinational in scope and organized in such forward-looking groups as the Committee for Economic Development, favored lowering tariffs, whereas small-scale industry in such lines as textiles and shoes, and belonging to the National Association of Manufacturers, clung to protection. Agriculture remained ambivalent, wanting export markets for grain, cotton, tobacco, oil seeds and the like, but fearful of the competition of Canada in some of those lines and of Australia and Argentina in meat, wool, and butter.[16]

In order to reduce the opposition to the program of lowering tariffs, successive Democratic and Republican administrations sought various concessions: the doctrine of no injury, the escape clause where injury was felt, and peril points below which tariffs could not be reduced—all of which bespeak protectionist ideology. Agreements were signed with foreign exporters to restrict sales to the United States, the International Trade Commission was established, trade adjustment assistance was instituted, and the courts were used to

[16]See Charles P. Kindleberger, "U.S. Foreign Economic Policy, 1776–1976," *Foreign Affairs* 55 (January 1977): 402.

judge certain complex cases. Concessions were made to interests with congressional clout, but the executive branch kept an ever-watchful eye on Congress to avert another spate of log-rolling such as produced the monstrous Hawley-Smoot tariff of 1930. The process is reminiscent of the myth of Atalanta and the golden apples, when a suitor who would win her if he beat her in a footrace resorted to slowing her down with three golden apples suitably dropped as she overtook him.

Most recently, President Reagan, who believes strongly in free trade, yielded up another golden apple in the form of a tariff on motorcycles to benefit the Harley-Davidson company, the last motorcycle business left in this country, but the tariff is slated to diminish and disappear in five years. The firm has undertaken a commitment to re-equip itself and reduce costs so that it can compete without a tariff at the end of the period. Disappearing tariffs have been recommended by economists in the past as worse than free trade but better than permanent tariff increases. However, many economists have been skeptical, recalling the cynical French aphorism that nothing endures like the provisionary, and doubting that the promised reductions would take place on schedule. In any case, it affords an interesting debate whether Harley-Davidson can shift from Keynesian to Schumpeterian growth and reduce costs so as to be able to compete eye to eye with Honda and Suzuki. It is also a test for the executive branch of government in the next administration: If Harley-Davidson should not make the grade, will that administration let the company go to the wall?

The Danger of Rising Protectionism

Olson's analysis of the gradual encrusting of American political and economic life by coalitions that serve parochial interests instead of the general interest and block one another through the fallacy of composition, suggests a mournful prognosis for tariffs. Aging is leading the United States to shift from Schumpeterian to Keynesian growth. The rise of Europe, Japan, and the Pacific rim countries and the loss of U.S. dominance in world affairs mean that the United States is now less favorably inclined toward free trade for itself. Moreover, even were the United States to cling to free trade itself, it would have less and less success imposing it on others, as it did from 1934 or 1941 to about 1971, and as Britain did in the mid-19th century. The world now appears to run a strong risk of moving into another protectionist era, like that from 1880 to 1930.

Arguments against Free Trade

The classical exceptions to the doctrine of free trade, allowed by such an economist as Adam Smith, have been national defense—the protection of industries that are needed in wartime—and the infant-industry argument. The liberal, mainstream market economist has a ready answer to these arguments. On the national defense argument, he insists first that patriotism is the last refuge of a scoundrel, and many an industry will trot out national defense as a claim for protection with little real justification; and second, that anything a tariff can do, another policy can do better. A subsidy to a necessary defense industry avoids handing out excess profits to inframarginal producers who could keep going without a tariff, and it will allocate the costs of expanding production at the margin in a more equitable way than loading them on the consumer. To the infant-industry argument, the usual reply is that many of these industries turn out to be midgets that never reach full height. And that of course is likely to be true in an economy with Keynesian rather than Schumpeterian growth.

The best example of infant-industry success I know was the U.S. steel industry's response to the McKinley tariff on tinplate. From the 1880s, U.S. demand for tinplate grew by leaps and bounds. Exports of tinplate from Wales to the United States rose more than five times, remarkably without any effect on the technology used by the producers who continued to coat iron sheets in baths of tin solution, sheet by sheet, dipped by hand. The tariff in the 1890 McKinley schedule led to the U.S. production of tinplate, initially with workers from Wales. A new technology was soon developed in which the iron sheets were produced in rolls that were continuously pulled through the tinplating baths. The new technology was resisted by the imported workmen, but those who resisted were sent home. In a few years tinplate imports from Wales dried up, prices fell, and the American industry started to export. This was proof positive that the infant had matured from an import-competing baby to an exporting adult.[17] It is difficult to envisage that tariffs or quotas could stimulate today's U.S. steel industry into innovative activity. Higher prices for steel products would more likely accelerate the rate at which management and capital quit the industry. For instance, when U.S. Steel purchased the Marathon Oil Company at the peak of oil prices, it used so much of its cash and credit that it is unable to refurbish its steel plant with modern equipment to lower costs.

[17]W. E. Minchenton, *The British Tinplate Industry: A History* (Oxford: Clarendon Press, 1957), pp. 63–71.

Despite the success of the tinplate industry, tariffs have not often contributed to national prosperity. I leave aside the Hawley-Smoot tariff of 1930, because the harm to U.S. prosperity came less from that tariff than from the retaliation to it by 30 to 40 other countries. In a Keynesian model without retaliation, a tariff may raise income by diverting spending from foreign to domestic products. If retaliation takes place, however, it may harm national income, depending upon how extensive it is. In 1930, retaliation was very extensive, although how this could have been predicted sufficiently in advance to result in the stock-market crash nine months before the bill was complete and signed, as Jude Wanniski claims,[18] is difficult to see.

In today's world, as U.S. leadership is slipping and the U.S. free-trade example for the world is at best fitful, it is hard to imagine that a substantial tariff increase in this country would not be followed by sizeable retaliation and serious injury to American exports and national income. More interesting perhaps than the Keynesian implications of sizeable tariff increases, however, are the Schumpeterian implications. How might tariff increases affect the drive for modernization and innovation?

To discover the effects of tariffs on modernization and innovation, we can first examine the French Méline tariff of 1890. This tariff was designed to keep American, Australian, Argentine, and Ukrainian wheat out of France. The French had a strong and beneficent motive, to preserve the French family farm and the peasant's way of life. The effort was successful, but at what a cost![19] While the nonfarm sectors of the economy experienced modernization, including both productivity and sociocultural development, the peasant was left behind. It was not until World War II that the French agricultural sector—which was mired in an archaic technology, primitive housing, limited income, shrinking farms, with its proprietors suffering from alcholism, miserliness, poor health, and limited education—started its transformation. After the war the agricultural sector shrank rapidly, declining from 64 percent of the economically active population in 1896 to 16 percent in 1968. Admittedly lower tariffs did not make much of a contribution to this reorganization in agriculture, which was powered by the strong sociopolitical forces generated by defeat and occupation during the war. The tariff of the 1890s and the quotas on imports of grain from the 1930s to World War II, however, subverted

[18]Jude Wanniski, *The Way the World Works* (New York: Basic Books, 1978).

[19]E. O. Golob, *The Méline Tariff: French Agriculture and Nationalist Economic Policy* (New York: Columbia University Press, 1944); Michel Augé-Laribé, *La Politique agricole de la France de 1880 à 1940* (Paris: Presses universitaires de France, 1950).

any drive for modernization and innovation that French agriculture may have had.

The classic case of attempted and failed import substitution is that of Argentina, a rich agricultural country that strove after World War I to develop industry with the help of tariffs. It happens that import substitution is a "natural" process in economics, though the use of the word in this field makes me uneasy. As a country gets richer, its demands rise for a variety of goods. Many of these are market-oriented, and when the demand is large enough there is an inevitable move to produce locally for the market rather than import. Sometimes the process is assisted by tariffs, but often it takes place without them. The economy has to be responsive to price incentives and capable of reallocating resources. Such a region as the Pacific Northwest of the United States and such a country as Denmark started out specializing narrowly in a range of products. Bit by bit the growth of income from successful exports led to increases in income, which attracted industry to products that used to be imported. When this import-substitution process is market directed, it takes place without planning. Mistakes are corrected by the failure of inefficient firms and successes are capitalized on by reinvesting profits.

Import substitution in Argentina, on the other hand, was a planned process, using tariffs, and the mistakes were enormous. Moreover, when various hothouse industries wilted, the response was to raise the tariff still further. Goods that could have been bought cheaply with the proceeds of exports were produced expensively at home, while rising costs priced Argentine goods out of their usual export markets. From one of the richest countries in the world, per capita, on a par with Australia and Canada and close to the United States in 1900, Argentina slipped drastically to the middle range of developing countries. One should perhaps be ready to blame sociopolitical factors that prevented the country from developing the Schumpeterian qualities of innovation and successful, undirected import substitution, but the tariff led the country in a direction it was not well equipped to go in.[20]

Is America Slipping into Keynesian Growth?

Is the United States aging, slipping from Schumpeterian into less vigorous Keynesian growth and slowing down in adaptability and capacity to transform because vested interests are choking it? The

[20]See various essays by Arturo O'Connell, Marcello de Paiva Abreu, and others in *Latin America in the 1930s: The Periphery in World Crisis*, ed. Rosemary Thorp and E. V. K. Fitzgerald (London: Macmillan, forthcoming).

answer seems almost certainly to be yes, although when I said so some years ago Peter Passell said I was indulging in Spenglerian nonsense. Does trade policy have anything to do with the speed with which a country ages, or is it only a result of arteriosclerosis? Much depends in the answer to these questions on political leadership—how farsighted it is—and on political followership, how ready the voters are to throw out administrations and members of Congress who are prepared to allow the economy to undergo some harm in the short run in a gamble that it will do better in the long run. Imports can break up distributional coalitions that take care of themselves at the expense of the commonwealth.

Some years ago, the Nixon, Ford, and Carter administrations had the power, and I think the duty, to say that the steel unions and the steel industry could make any deal on wages they chose, but that the executive branch of government would *never* cut off imports to rescue them from its consequences. Today the Reagan administration is under pressure from Michigan congressmen to extend the restrictions on exports of Japanese automobiles to the United States—export restrictions that the Japanese industry was forced to adopt for a limited period and that expire in the summer of 1984. The American automobile industry was given time to shake down, improve productivity, reduce costs, and zero in on some wage rate that would be in equilibrium in a competitive world; and some firms did. If the period is extended, it will be obvious that the government of the United States is not serious about trying to shift from a Keynesian world to one in which industry has to produce efficiently or go under.

Is the Dollar Overvalued?

An important side issue here is the overvaluation of the dollar. Our foreign economic policy today is something like "the house that Jack built": This is the dog that chased the cat that caught the mouse that ate the cheese, and so on. The cut in taxes combined with the increase in military spending produced a big deficit that increased interest rates and attracted capital from abroad, that bid up the price of the dollar and worsened the competitive position of import-competing industries. To a considerable extent, I have been praising the Reagan administration in this paper for taking a strong stand against tariffs—albeit mitigated by the judicious tossing of golden apples from time to time—and being unfriendly to U.S. businesses and unions for their rent-seeking activities and their piteous pleas for protection. To a degree, however, the faulty macroeconomic policy of the administration has contributed to dollar appreciation and overvaluation—if one believes as I do that purchasing-power parity is not attained

under flexible exchange rates at every hour, day, week, month, year. This makes it hard for American labor and American enterprise. I should very much welcome the same ideological approach to free trade in which I believe, and a different ideological, or even better a pragmatic, approach to macroeconomic policy where I do not accept the supply-side nonsense peddled by some of my friends. On the other hand, if one is ready to accept the second best and thinks it is impossible to modify U.S. macroeconomic policy before early 1985, then the question becomes whether one ought to accept a misguided commercial policy to offset our misguided macroeconomic policy. That sort of "second-best" reasoning is widespread historically. The Fordney-Macomber tariff of 1919 was adopted partly in response to exchange depreciation thought to lead to exchange dumping abroad.[21] On the whole, I remain a first-best man: I want an equilibrium exchange rate and a policy of free trade to break up distributional coalitions. I understand the folk saying that the best is the enemy of the good, but I was also brought up on "Good, better, best, never let it rest."

Conclusion

Let me close with another second-best problem. In a paper for a Swiss journal, I suggested that the two cycles in free trade—the British cycle starting in the mid-19th century and the American cycle a century later—might both be followed by eras of protectionism. What then? A new world leader strong in Schumpeterian growth and ready to twist arms to usher in a new era of free trade: Japan? Brazil? the Soviet Union? China? a dark horse? But there is another possible scenario. It could happen that all countries approach freer trade together as the multinational corporation, widely based, makes clear to national governments throughout the world its interest in free trade; an interest based on its being better able to move inputs and outputs around the globe in an efficient way, buying cheap and selling dear. In this view national sovereignty is weakened by cheap transport of goods, people, technology, information, and ideas. Large firms want and politically are able to obtain the freedom to arbitrage widely.[22]

[21]See Charles P. Kindleberger, "Commercial Policy between the Wars," in *The Cambridge Economic History of Europe*, vol. 8, ed. Peter Mathias and Sidney Pollard (Cambridge: Cambridge University Press, forthcoming).

[22]See Charles P. Kindleberger, "Le Libre-échange demain pourrait être imposé par les multinationales," *Le Temps Stratégique* 3 (Winter 1982–83): 95–100.

Political scientists are horrified at the idea that the rise of the multinational corporation and world-wide markets shrink the domain of the sovereign nation, leading to harmonization or homogenization of policies in the fields of money, taxation, business regulation, standards, and, I would add, commerce. Some years ago, Stephen Hymer asked rhetorically which would last the longest: General Motors or France. I was never completely clear what answer he had in mind, but I think it was France. Political scientists such as Stanley Hoffmann and Nicholas Wahl surely feel the same way, but perhaps they forget the demise of earlier political units: the Italian city state, the German principality, the United States county, the French department, and most recently, the serious weakening of state government in this country. I am not unaware, let me add, of the devolution movement in Scotland, separatism in French Canada, and the strains between the Flemings and the Walloons, but I regard the movement toward larger economic units as more compelling.

If free trade is associated with the multinational corporation, believed by some economists and many citizens to be monopolistic, which way should the mainstream liberal economist and citizen go? Many years ago, I recall, some Kansas "farmers" made the argument in congressional testimony that they had been taught to be against monopoly and in favor of free trade. Since free trade in oil was the policy advocated by the major oil companies, who were monopolists, the farmers had reluctantly decided that to be against monopoly meant being in favor of free trade; hence, they wanted a tariff on foreign oil. These farmers may have grown some grain and raised some meat, but I suspect that most of them also had oil derricks in the back forty. The argument was largely one of "little oil" against "big oil," with big oil importing from abroad and lowering the prices that could be charged by the purely domestic industry.

The conflict arises from the fact that the optimum economic area is the world, whereas the optimum social area is much smaller—with the optimum political area somewhat ambiguous and dependent upon whether you are ambitious for power, like Bismarck and De Gaulle, or seek the quiet life like Denmark today. To an economist, one should buy cheap and sell dear as widely as possible, given the constraints of transport costs. For social happiness, one wants to belong to a community where one is known, has a sense of participation and belonging. If there is a clash between the optimum economic area and the optimal social area, then one's choice will depend on the arguments and their weights in one's preference function.

But there is another approach: As a positive rather than a normative question, should one expect the politics or the economics to dominate

in the long run? I happen not to be a Marxist but I suspect that in the years ahead, as so often in the past, economic considerations will win out over social and political. If that is what we can expect, there is a strong case for moving toward free trade and competition among countries, and for building world institutions to apply uniform regulation, taxation, and the like in a fair manner and to block arbitrage based on uneconomic differences. We need to work toward harmonized macroeconomic policies for world stability and to correct for market failure in fields such as monopoly, and correct for income distribution where our ethical judgments require it. In the long run, we need to think not only of national prosperity but of international prosperity as well.

SOME EMPIRICAL RESULTS ON TRADE AND NATIONAL PROSPERITY

Edward Tower

Professor Kindleberger's (1983/84) paper, "International Trade and National Prosperity," touches on some of the most crucial issues facing international policy makers. Among these are the following:

1. What do tariffs and import-substitution strategies do?
2. What is the appropriate role for infant-industry protection?
3. What is the outlook for protectionism in the United States and in the world economy?

I would like to offer a bit of recent empirical evidence on the first two points, and some additional thoughts about the third one.

Tariffs and Import-Substitution Strategies

The ideal set of policies is one in which the most efficient possible combination of instruments is assigned to correct externalities and mitigate inequity in income distribution. As we know this leaves a very limited role for tariffs. Ideally a tariff should be used only when the government's target is to reduce imports or reliance on foreigners, and any other target should be met by a different instrument.

But suppose we are bound to use tariffs because the political process is for some reason too cumbersome to use the ideal set of tools. What would we expect the structure of tariffs to look like? I would expect that in line with conventional rhetoric we would see tariffs protecting jobs, and especially the jobs of the underpaid. This translates into expecting to find that tariffs protect sectors that are relatively intensive in unskilled labor.

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Let us examine the evidence for the United States. In a recent study Kreinin (1984) examined developments in American motor vehicles and steel. He finds that for 1982 the ratio of labor compensation in motor vehicles to that in all manufactures is 165 percent for the United States but considerably less for American competitors. He concludes that to be competitive with Japan in the motor vehicles industry, U.S. labor compensation would have to decline by 24 percent. Even then it would still remain above the U.S. manufacturing average by 25 percent. Similarly in the United States the ratio of labor compensation in iron and steel to that in all manufactures is 189 percent. In this case American wages would have to decline by 39 percent to restore competitiveness with Japan. But this would still leave labor compensation in this sector at 15 percent above the U.S. manufacturing average. Thus in neither of these sectors can it be said that protection is being used to subsidize relatively downtrodden labor.[1]

On the issue of whether tariffs create jobs in the sense of tending to push the full-employment wage up, Hartigan (1981) provides important material. He finds that the height of the American tariff in 1967 was positively related to the capital intensity of the sector in question, and this is also true of the tariffs levied on American goods by her trading partners.

Along these same lines Hartigan and Tower (1982) used a linear programming model to simulate the impact of tariff changes from the 1967 base on the American income distribution. They found that the U.S. tariff structure tends to protect U.S. capital at the expense of U.S. labor, so that American labor had an interest in unilateral tariff reductions. Moreover, foreign trade barriers, since they are also relatively higher on capital-intensive goods, ended up protecting American labor at the expense of U.S. capital. However, not surprisingly they found that reciprocal tariff elimination would tend to benefit both factors, while tariff wars would hurt labor slightly and benefit American capital. They also found that the group of nonfarm labor that had the most to gain from unilateral reductions in American tariffs and reciprocal tariff reductions was unskilled labor.[2] These simulations rely on a very simple model so the results should be considered little more than suggestive. Nonetheless they certainly

[1]Several studies, however, have found evidence that the extent to which sectors are protected depends negatively on their average wage both for the United States (Fieleke 1976) and Canada (Helleiner 1977).

[2]The results reported here assume that tariff reduction is slow enough that resources have time to reallocate themselves between sectors and that bottlenecks in the supply of capital to particular sectors do not arise.

do raise doubts about whether U.S. tariffs serve the goal of equalizing the distribution of American income.

Similar results have been discovered for other countries. In a volume summarizing the results of examining trade policy in 12 less-developed countries (LDCs), Krueger (1983, p. 186) finds that, "The extent to which there may have been interaction between inner-oriented trade strategies and factor market distortions, both leading to high capital/output ratios and low rates of increase in the demand for labor, is striking." The reason for this is that LDCs tend to import more capital-intensive goods than they export. Thus import-substitution strategies tend to raise the output of relatively capital-intensive sectors, and by appreciating domestic currencies they make it harder for LDCs to sell their relatively labor-intensive goods abroad. Import substitution, therefore, stimulates sectors with excessively high capital/labor ratios and results in low rates of increase in the demand for labor. The result of all this is an adverse swing in the income distribution away from labor. Krueger (p. 187) concludes that incentives created under an import-substitution regime are "ad hoc, specific and widely varying" and they "do not usually provide the resource allocation gains that can result from uniform, across-the-board incentives."

What is striking to the readers of these studies is how similar all of the stories sound. A special horror story is T. Paul Schultz's (1982) finding that the structure of effective protection in Colombia increased employers' earnings proportionately three times as much as employees' earnings. The 1983 edition of the World Bank's *World Development Report* offers further evidence regarding the failure of tariffs and import-substitution strategies to foster national prosperity. In that study it was found that of a sample of 31 LDCs, those countries with greater distortions had *lower* growth rates, on average, than those countries having relatively fewer distortions. Price distortions were found to explain about one-third of the variation in the growth rates between the high-distortion and low-distortion countries (1983, p. 63).

Another series of studies is reported by Krueger (1983, pp. 42–46). In one of them, Michalopoulous and Jay (1973) essentially fit an aggregate production function to 39 developing countries for the period covering the 1960s. They find that countries that export a larger fraction of their domestic output have higher factor productivity, and that, "The growth rate of GNP and the growth rate of exports are highly correlated with each other" (p. 22). Krueger reports similar findings by Balassa, Krueger, Michaely, and Heller-Porter. A growing body of evidence is therefore available to support the notion that

commercial policies, in general, are not in a country's long-run interest—they promote neither equity nor efficiency.

The Appropriate Role for Infant-Industry Protection

We now turn to the second issue I wish to discuss; namely, empirical information on the appropriate role for infant-industry protection. In his study, "Empirical Justification for Infant-Industry Protection," Westphal (1981) found that during the first five to ten years of production in an LDC, it may not be unusual for production costs to fall by as much as 10 percent a year in certain activities. From this observation, he concludes that initially it may be reasonable to grant net effective rates of protection of up to 100 percent. However at the birth of the enterprise the future path of the effective rate of protection should be announced and subsequently followed both to minimize the cost to consumers and to serve as a signal to entrepreneurs to take immediate advantage of the incentives provided.

Westphal asks whether the infant-industry argument should be used for simultaneously protecting a wide range of industries. His answer is a resounding no, because to protect a particular sector is to implicitly tax all the other sectors from which resources must flow. When infant-industry protection runs wild, it ends up offering very little real protection to any sector. Accordingly, he concludes, "protection to infant industries appears to offer a viable means of fostering rapid industrial development, but only if a relatively small number of infant industries is promoted at any one time" (p. 19). Also, limiting the number of protected sectors is particularly important in LDCs where economies of scale are crucial and certain resources are in especially short supply.

Westphal (p. 30) notes an important conclusion from studies of various countries; namely, "exporters enjoy virtually costless access to a tremendous range of technological improvements that are diffused to them through various activities of the buyers of their exports." This is yet another reason why LDCs need to rely on trade. Along similar lines Krueger (1983, p. 51) writes:

> While it is obvious that a firm starting to produce a product previously not manufactured in a country is very likely to sell to the domestic market first . . . experience demonstrates that this is not inevitable. In fact one major way of starting new industries and new product lines . . . has been for firms in developed countries to subcontract with foreign suppliers to fabricate particular parts and components. In some instances the foreign buyer provides technical specifications, technical assistance and even capital.

Thus it seems that the infant-industry argument is at best an argument for subsidizing trade, not for taxing it.

Finally Westphal (p. 33) recognizes that for the infant-industry protection strategy to work, it is very important

> to recognize mistakes and take remedial action quickly, as well as to learn from past mistakes in making future choices. These and many other conditions imply that selective infant industry promotion requires a very high level of competence in its administration. Such competence can be learned, but it is apparent that conditions conducive to its being learned and effectively applied are not present in all countries.

In fact Krueger and Tuncer (1982) found in their study of Turkey that the infant-industry rationale for protection did not apply because there was no tendency for input per unit of output to fall more rapidly in more-protected industries. Thus, to add to the well-known theoretical case against infant-industry protection (see Corden 1974), we have empirical evidence that the policy is likely to work only if it is applied with a precision that does not adequately describe the political process of tariff setting as we know it.

The Outlook for Protectionism in the United States and World Economy

Kindleberger sees U.S. leadership slipping and the U.S. free-trade example unconvincing. He therefore expresses concern about whether the momentum toward freer trade will continue. The average U.S. tariff on all imports is only 3 percent, which is less than it has ever been since America imposed her first tariff in 1789. Yet, America is not a free trader—the United States is party to international agreements on trade in cocoa, coffee, rubber, sugar, and tin. There are also trigger price mechanisms in steel and "voluntary" quotas on autos and textiles. Nevertheless the United States economy in the 1980s is more open than ever before.

Reassuringly we no longer have a major political party that is ideologically committed to protectionism. But as Kindleberger puts it, neither do we have one that is adverse to dropping golden apples. A body of statistical evidence has developed starting with Pincus (1975) that indicates why we cannot think of existing patterns of protectionism as having been designed in order to maximize a social welfare function. Instead the interplay of political forces leads to tariffs that favor those groups with the greatest political power. A second body of statistical evidence also has developed, starting with Little, Scitovsky, and Scott (1970), that emphasizes the importance

of trade in the development process. The recent consensus of development economists is much less in favor of import substitution and much more inclined toward reasonably free trade than it was in the 1950s. Finally the World Bank with its structural adjustment loans—which are in effect bribes for freer trade—is taking a stronger pro-market stance than ever before. All these forces should have an impact on making trade freer than it would otherwise be.

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