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International Trade and Economic Relations

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INTERNATIONAL TRADE AND ECONOMIC RELATIONS

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The theory of international trade was developed in the nineteenth century — an era of relative tranquility, surprisingly lacking in national rivalries, which accepted as axiomatic the view that the primary economic goal was to enhance the material well-being of the individual consumer. The essence of the theory was that free trade would contribute to that end, since all nations would benefit if each specialized in that type of production in which it had a comparative advantage and traded with others for the additional supplies that were needed. It can be demonstrated that even a nation that has an absolute advantage in the production of several commodities would benefit by concentrating upon that commodity in which its relative advantage was greatest, and would obtain more of those commodities in which its relative advantage was less, through indirect production — that is, by trading with other nations, sending to them the product which it could produce most efficiently and obtaining in return those products which it could produce less efficiently.

It should be emphasized that the theory was based upon an assumption of natural harmony among nations and peoples which was tenable, perhaps, until the breakdown of the balance of power at the time of the First World War. There can be little doubt that — from the cosmopolitan view, and aside from the relative benefits to be enjoyed by the several nations — an absence of restrictions on trade would provide the greatest availability of goods at the lowest prices to the world's population, and thus provide for maximum material welfare and maximum consumer satisfaction.

Even in the nineteenth century, however, objections were framed to the idea of free trade in the name of: (a) national interest; (b) producer interest; and (c) non-economic interest. Traditionally, the only restriction upon trade came in the form of the tariff. The arguments in behalf of tariffs, as opposed to free trade, are worthy of note. Many of these arguments are wholly erroneous and were designed for propagandistic purposes, but there were several that had validity: the defense argument; the infant industry argument; the vested-interest argument; and the argument in favor of the tariff as a weapon of retaliation or to improve the terms of trade. With respect to the American economy at the present time, the only relevant issues are the defense and vested-interest arguments. Certain industries have long been recognized as contributing to national security. Adam Smith, himself, mentioned the merchant marine. Even if it were cheaper to use the services of foreign states, it may be argued that it is necessary to protect from foreign competition an industry which contributes to national strength. "Defense," said Adam Smith, "is more important than opulence." It certainly may be argued that in the modern world many industries are vital to national security and ought to be protected. The vested-interest argument would hold that we ought to protect certain industries and regions against unemployment of men and of capital equipment, with the consequent drain on the nation's resources in the form of unemployment compensation and psychological *malaise*. It poses a difficult question, to which I will turn back later.

It would seem to me that in the light of the strength and dominant position of the American economy we need no longer concern ourselves with the use of tariffs to extract concessions through the threat of retaliation; or, need we attempt to improve our terms of trade. The infant industry argument no longer applies, since American industry consists of brawling giants rather than squalling infants — although the giants do occasionally squall like infants for protection.

Nineteenth-century commercial policy in the United States was protectionist in design — based largely upon infant industry arguments. Protectionism was in harmony with a strategic position based upon continental isolation and a desire to avoid entangling alliances. Trade is one of the entanglements which has from time to time threatened our continental security. It is notable that the chief menace of foreign intervention in American affairs — that of British intervention in behalf of the Confederacy during the Civil War — arose in no inconsiderable degree from the fact of raw material starvation in the Lancashire cotton mills, a consequence of the snapping of the normal ties of trade. From time to time, the United States has been drawn into wars originating in Europe due to the ties of commerce and the interference with seaborne trade. American involvement in both the War of 1812 and the First World War may be in large part explained in this way. Obviously, international commerce is fraught with power implications. During the era of continental isolation, the typical American response to the power implications of trade was to avoid them. The answer came in the form of embargo acts to prevent American involvement —— and even, indirectly, in foreign quarrels. We thus had Jefferson's Embargo Act of 1807 and the neutrality legislation of 1935-1937. The latter reflected the disillusionment with American entry into World War I. It was the lure of trade accompanied by the machinations of the 'merchants of death' that brought about American involvement. This attitude suffuses the writings of the distinguished historian, Charles Beard.

In the nineteenth century, we, the American people, were willing to forego many of the advantages of international trade. We were willing to hide behind tariff walls and, down to the change in our international financial position — which occurred during the First World War — the only cost of this policy was the loss of the benefits of trade. Since 1920, our commercial policy has been irrational. With respect to its strategic implications, a policy of continental isolation would seem to be defensible down to the fall of France in 1940. Conceivably, it could be defended until the advent of the nuclear age. It is clearly out-of-date today.

II The Strategic Implications of Trade

International trade is fraught with strategic implications. The central issue with respect to trade *in the present era* is how it affects the relative power positions of the several national states. Some nations have been provided with the sinews of war through trade. At the same time, a nation dependent on foreign supplies is at a disadvantage if its normal trading channels can be interrupted. The existence of a significant volume of trade provides one state with a weapon for influencing the policies of another state.

The power influences of trade may be divided into two parts, which we call the supply effect and the influence effect. The supply effect itself has two aspects. In the first place, international trade is the route by which certain nations, rich in some resources but poor in others, have achieved affluence — and affluence, as Bentham observed in opposition to Adam Smith, is necessary to defense. By participating in trade, a nation may sharply raise its total and per capita income and thus may provide that margin of resources which is essential to national power. Unless there is a disposable margin, a nation is unable to allocate sufficient resources to provide itself with the instruments of security. In modern terms, trade adds to a nation's economic potential for war by enlarging its national product. But, the supply effect may add more directly to a nation's power by providing directly the sinews of war. Through trade, then, a nation's relative power may be sharply increased; yet, it opens it to the risk of interdiction during war. Britain's control of trade routes, for example, long posed a threat to any potential rival.

The second strategic facet to trade is the influence effect. A state may use trade as a weapon of economic penetration. By bringing about a condition of mutual dependence through trade, a state may have an instrument to influence the foreign policies of other states. From the national point of view, it is desirable to bring about a condition in which the severance of the trading connection would be more damaging to the trading partner than to oneself. It will be seen that this asymmetrical dependence may most easily be achieved by great industrial nations in dealing with small primary producers of raw materials dependent upon the sale of one crop. Trade thus may bind together national policies through ties of mutual interest and the fear of dislocation. It can be seen that the supply effect may, to some extent, conflict with the influence effect. The harder the bargain is driven to obtain needed supplies, the less likely is it that the particular market involved will be viewed by the supplying nation with the mixture of affection and fear which maximizes the influence effect.

A type of trade that is particularly potent in terms of the application of power is transit trade. In this case, both the buyer and the seller are threatened by a loss of trade; yet, the nation that severs the trade is likely to have relatively little at stake. I need not point out to you how important an issue this is at the present time in the Middle East. Syria and Egypt are astride the oil transit routes and are in a position to threaten both the oil-producing countries of the Middle East and the oil-consuming nations of Western Europe at relatively little cost to themselves.

It was an illusion of those nineteenth-century thinkers who developed the theory of international trade that the power implications of trade could be overriden. They assumed that a harmony of interest existed among nations, and that this harmony might be fostered by trade. John Stuart Mill observed in a famous quotation that "it is commerce which is rapidly rendering war obsolete by strengthening and multiplying the personal interests which are natural opposition to it." The hopes of the nineteenth century have been crushed by the realities of the twentieth: It may also be added that, instead of always assuaging frictions, trade has been one of the great causes of international friction. Power implications are inherent in trade. They may be ignored but, nevertheless, they exist. The development of political controls over trade in the twentieth century simply makes overt what had hitherto been tacit. The harmony assumption had merely glossed over the inherent power possibilities.

III American Commercial Policy

I have already commented on the tariff barriers that were erected by the United States in the nineteenth century and culminated in the Smoot-Hawley tariff of 1930. Various arguments were contrived to defend tariffs — some were tenable; most were grossly fallacious. By and large, we were willing to forego the material advantages that might be obtained by an international division of labor in which we concentrated on the production of those commodities in which we had the greatest comparative advantage. The price we paid was the wastage of scarce resources on the production of commodities that we could have imported more cheaply. We were rich, however; we had a continent's resources to exploit, and so we could afford it. I have emphasized that the policy of tariff protection was in harmony with the strategic doctrine of isolation.

In impeding the flow of trade, our tariff barriers gave rise to a legacy of vulnerable domestic industries that cannot survive without tariff protection, thereby creating a legacy of problem industries which haunt us in the formulation of commercial policy at the present time. Since the passage of the Trade Agreements Act in 1934, there has been a steady pressure toward the reduction of tariff walls. The nation has come to recognize some essential truths of commercial policy. One is that unless you are willing to buy from foreign nations, you will not be able to sell goods to them. Another truth is that certain foreign countries are dependent upon trade for survival. Unless they trade with us, they may be tempted to trade with somebody else — and that somebody else might well be the Soviet bloc, thereby leading to *excessive* dependence upon our rivals. A third truth that has increasingly come to be recognized is that there is little point in wasting scarce resources to produce a commodity when you can import it more cheaply; international specialization provides lower prices for consumers and higher real income for all citizens. The newer attitudes may be subsumed under the polemical slogan of "trade not aid."

Under the circumstances, those branches of industry that have been seeking protection have been faced with the need for a new propaganda argument. The older protectionist arguments — building domestic industries, the scientific tariff (so-called), the pauper labor argument, and so on — have lost their appeal. The chief argument against trade liberalization today that is widely accepted is the defense argument; to a lesser extent the vested-interest argument in the form of "men being thrown out of work" excites some sympathy. It is quite natural, therefore, for an industry presenting its arguments before the Tariff Commission to attempt to come in under the national security umbrella.

Now, the defense argument on behalf of tariff protection is essentially this: that if a certain industry is vital to national security, and even if the nation lacks a comparative advantage in that type of production, it is desirable to ensure a market by granting protection. Obviously the commodity or service must be a vital one; the stronger the danger of interruption of supply during wartime, the greater the force of the argument. Some industries immediately spring to mind as possible recipients of tariff support: synthetic rubber, the merchant marine, chemicals, perhaps aluminum and watch manufacturing. But some of the contentions, as Raymond Vernon has observed, are close to absurd:

> In the name of defense, the dairy lobby succeeded in restricting imports of foreign cheese. The lace manufacturers claimed defense status because

> they manufactured soldier's gloves; the cutlery producers because they manufactured machetes; and the lead-pencil producers simply because pencils were 'indispensable.'[1]

To illustrate the popularity of the defense argument among industries seeking protection, let me cite the testimony of a spokesman for the Schiffli Lace and Embroidery Manufacturing Association before the House Ways and Means Committee:

> . . . It is important to remember, however, that in a time of national insecurity and peril, it was the one and only industry the United States military forces could turn to for the manufacture of all the shoulder patches and insignia . . . considered vitally necessary for the morale of our soldiers and sailors . . . no industry capable of producing such a valuable military commodity should be allowed . . . to wither and become extinct because of the lowering of tariff rates . . .[2]

I think that this little excerpt gives you some idea as to how widespread in American industry is the altruistic concern for national security and the well-being of the members of the armed forces. It may be that it also illustrates the strong tendency for vested interest to wrap themselves in the flag and to present private concerns as a part of the national interest. It tends, furthermore, to corroborate an original supposition: we must scrutinize carefully any claim that tariff protection is necessary for defense.

In its place, the defense argument for protection has a certain validity; its applicability to American policy at the present time is more in dispute (and to this point I will return later).

1Raymond Vernon, "Foreign Trade and National Defense," *Foreign Affairs,* October, 1955, pp. 77-78.

2Quoted by Berhman and Schmidt, *International Economics* 1957, p. 53.

For the present, we must content ourselves with the following observations: (1) The chief purpose of tariff protection in the case of defense-sensitive industries is to add to what we called last time the "mobilization base" of the economy. (2) The reason for adding to the "domestic mobilization base" is fear that foreign sources of supply may be interrupted in wartime. We desire to decrease our dependence on trade over which we have little control. But it must be remembered that severance of trading links reduces the dependence of others, as well as ourselves, on trade; therefore, it may add little to our relative strength. (3) Certain of our industries are export-oriented and, at the same time, contribute to our mobilization base. Among them are automobiles and agricultural implements, chemicals and machinery of all descriptions. By building up an export market, we bring about the expansion of such industries and thereby add to our "mobilization base." Since it is necessary to purchase in order to export, foreign trade may in fact add more to our mobilization base than the impeding of trade.

Now that I have perhaps instilled in you some skepticism with respect to the ease of applicability of the defense argument, let us turn to the examination of some specific examples of the application of the doctrine. Under the present law, as amended in 1955, the Director of the Office of Defense Mobilization, "whenever he has reason to believe that any article is being imported into the United States in such quantities as to threaten to impair the national security, he shall so advise the President, and if the President agrees that there is reason for such belief, the President shall cause an immediate investigation to be made to determine the facts." If the investigation demonstrates that there is a threat, the President is free to take whatever action he deems necessary. In 1954, the government acted to increase the duty on watches in the interest of national defense. The case for protection of the watch industry is quite complex, and I will not bother you with the details. There has been domestic protest over the decision; in Switzerland, there has been anger; in Europe, there was alarm, probably unjustified, that the United States was reverting to outright protectionism.

An even more complex case occurred this summer. A special Cabinet Committee, organized after notification by the Director of the ODM, reported that crude oil imports, then running at almost a million barrels a day in the affected area west of the Rockies, threatened to impair national security. The President then requested the major oil companies who do the importing to "voluntarily" reduce imports to 755,700 barrels per day — a cut of a little more than 20% — and to set as an importation limit 12% of U. S. petroleum output outside the Pacific Coast area. U. S. petroleum output has been running at the rate of about 2.4 billion barrels a year — almost 50% of world output, outside of the Soviet bloc. Simultaneously, we have been consuming about 55% of the Free World's output. At the present rate of domestic production, our proved oil reserves — almost 30 billion barrels — would last just over eleven years. At the present rate of consumption, our domestic oil reserves could supply us for just over ten years. Our domestic reserves constitute only about 20% of the world's total.

As a matter of simple arithmetic, it would seem that if the United States were to consume 55% of the world's oil production, and rely primarily on its own reserves, that our reserves would soon be depleted. Why, then, did the President take the action? It was his desire to build up a "thriving oil industry." The Cabinet Committee was concerned about the gap between exploration and production. Oil reserves are not static. It was hoped that the assurance of a domestic market would give a stimulus to the industry to go out and discover additional reserves. That was the rationale behind the decision; its wisdom has been questioned.

The rationale for limiting imports is to add to the industrial mobilization base, and the reasoning is clearly applicable in the case of the development of manufacturing facilities. But, oil is a *wasting asset*: the more that is taken out of the ground, the less there will be left to exploit. It becomes increasingly more expensive to discover and to produce additional oil as the more accessible deposits are drained off. Clearly, under these circumstances, the applicability of the "mobilization base" concept is questionable. Oil brought here from the Middle East can be sold 10% to 15% more cheaply than can domestically produced oil, despite tariffs.

Manifestly, in the event of war, we would not find all of our present consumption to be essential. Much of it is "luxury consumption," and it raises the question as to whether it is wise policy to go to the trouble of proving up expensive and vital oil reserves merely to see it go through the engines of America's fifty-odd million automobiles. If oil is vital, we ought to conserve our reserves rather than waste them. The implication of the President's argument is that it is a menace to our security if our rate of production slips to a mere 40% of the world's total. Maximum protection now is achieved at the cost of greater risk in the future. The present system is not well suited to our needs. Surely the problem of conserving oil is not too deep for the ingenuity of an administration that devised the soil bank. We might well develop an Oil Bank — paying bounties for discovery, and impounding the oil by capping the wells until it is needed. Subsidies can be paid to maintain the production of so-called "stripper wells."

Other issues may be raised with respect to the decision: (1) Is it implied that all oil imports are a similar threat to national security — that oil shipped from Tampico is sharply distinguished from that shipped from Galveston and is, instead, the strategic equivalent of that shipped from the Middle East? (2) Is it not desirable to develop Western Hemisphere oil resources? (3) Is this not a reversal of the administration's "trade not aid" doctrine — and how does it affect our relations with the oil-producing Middle Eastern countries whom we are simultaneously attempting to aid and to cultivate?

In a democracy, decisions result from an alignment of pressure groups. Behind public policy we may observe the operations of interest groups. The domestic oil producers in the United States are one of the most powerful of domestic interest groups — so powerful, in fact, that they are rarely used as a political target. They are deeply entrenched in both major political parties; they have enormous power in the Congress; and they are not without influence, as you can imagine, in dealing with congressional leadership. It is the height of folly to assert that it costs six times as much to discover oil at home as to discover it abroad, and then to burn up our valuable wasting assets in gasoline. It is ironical to observe glaring protectionism operating under the aegis of national security procedures. There is an element of farce in taking this action in the name of national defense. Perhaps, in the end, it will do little harm. As yet, voluntary restraint has been ineffective, but it is a warning to be ever alert to the role of pressure groups in the formulation of public policy. This is not to say that the decision-makers are consciously biased; yet, the issues are so many-sided — diversion of resources as opposed to dependence on foreign sources — that decisions do ultimately reflect the pattern of pressures.

IV The Role of Trade in American Foreign Policy

George Kennan has observed that "the problem of dealing with international Communism . . . is largely a matter of what we do in our relations with the non-Communist world."[3]

In those relations, trade has a distinct — perhaps an indispensable — role to play. In the nineteenth century, our national strategy was based upon continental isolation — and, under those circumstances, the impeding of trade through the protective tariff was consistent with our national purposes. In the mid-twentieth century, our national purpose is to prevent the further expansion of Communism; our role, as leader, is to hold together a coalition of non-Communist powers, greatly differing in aspirations and in strength. In holding together this coalition, trade

3George F. Kennan, "Realities of American Foreign Policy," Princeton, 1954, p.31

has a vital role to play. *The Counterpart of global defense is global trade.* Ideological bonds with foreign powers are potent, but they are even more potent when the nations concerned are linked together by mutual interests. Yet, our foreign economic policy seems to be based partly on autarkic concepts: the idea that we must produce all that we need at home. We state that we must prevent the expansion of Communism; yet, our policy seems to be based on the supposition that in the event of war the rest of the world will be lost to us as a source of supply. This is clearly untrue in the case of limited war. If, however, we refuse to trade with other nations, we may encourage the drift toward Communism. We must recognize that autarkic policies are consistent with a strategic doctrine based upon 'fortress America.' They are not consistent with the goal of maintaining a world-wide coalition of non-Communist powers. Now, some schizoid tendencies in our policies may be unavoidable. In this particular case of trade they may even be desirable, to some extent. But if we wish to maintain our coalition, we must do what we can to strengthen it — and not act as if foreign supplies are unacceptable because they are likely to be lost in wartime.

We must bind others to us through trade. As an influence, trade is an ideal instrument since it generally contributes to an all-round increase in real income. It is an instrument that should be uniquely accessible to the West. The Soviet Union tends to be autarkic; their external economic linkage is essentially limited to the Communist bloc. Either because they fear for their security or because they refuse, on ideological grounds, to rely upon regions not subject to their political suzerainty, they refrain from extensive trade with other countries aside from their satellites. Their total trade is small. When they do trade with countries outside of their own orbit, it is likely to be smaller states, like Egypt or Burma, where they can sow discord. The flow of goods *per se* is secondary. The Soviet Union does not seek trade with powerful partners, such as unsovietized Germany or Japan. Yet, it is a myth that prevails in the Western-oriented industrial countries that to the east lie markets (or, in the case of Japan, to the west, in Communist China). The Soviet bloc is, however, anxious to build up its own industry. If it desires to import, it is to import capital goods and not consumer goods. The Chinese have little intent to provide the Japanese with a market similar to the one which existed when Japan was the dominant power in the region. Despite the hopes of the Japanese, and others, trade with the Communist bloc ultimately offers relatively little in terms of total volume.

Some of the smaller nations have learned that the lure of a Soviet market is not quite as appealing as it may appear at first blush. The Soviets are not anxious to become dependent upon foreign sources, especially those that surely would be interrupted in the event of war. Relations with the smaller countries have had political, rather than economic, objectives. Egyptian cotton sent to Russia has been dropped upon the West German markets at low prices, thus damaging the local markets for Egyptian cotton. The same is true of Burmese rice. Soviet trade, up to the present time, at least, has been more of a come-on device to cause dissension in the non-Soviet world than has it been a device to create firm associations through the exchange of goods. Thus, in certain circumstances it may be desirable to permit members of the Western coalition to see for themselves the limits of the market in the Soviet camp.

That this is not always wise, particularly when dealing with the smaller countries, may be illustrated by the following Icelandic saga. Under present legislation, the Tariff Commission is obliged to conduct "an escape clause" investigation upon the request of a domestic industry. If the Commission discovers that imports are occurring in such volume as "to cause or threaten serious injury to domestic producers," it is to so report to the President, who may then accept, reject or modify its findings. In 1956, the Tariff Commission, upon investigation, discovered that the domestic ground-fish industry was suffering grievous injury from imports. Some hardship was occurring in fishing ports. Some of the people of New England were disturbed; their representatives in Congress were definitely disturbed. It was a clear-cut case for tariff protection on the basis of a threatened vested interest. President Eisenhower, in December 1956, however, rejected the findings of the Tariff Commission and decided against raising the tariff on imported ground-fish fillets. In the previous week, the Icelandic government had decided to permit American forces to remain in Iceland. The earlier decision was based upon a promise of the forthcoming action. Iceland must export in order to live. In 1955, the British began to exclude Icelandic fish as a result of a misunderstanding over the extent of Icelandic coastal waters. The Russians began to buy fish. By the end of 1956, they were buying 35% of Iceland's fish, which is almost the only Icelandic export. Their influence rose, and there came the threats about American bases. Then came the President's decision and the Hungarian episode, which helped persuade the Icelandic government (a coalition which included Communists) to permit us to stay on. It does, however, afford an excellent illustration of the importance of fish to American security, of the role of trade in achieving a world-wide defensive coalition, and of the problems which arise when it is necessary to sacrifice a domestic interest group to security considerations.

Foreign trade may be an excellent device for winning friends and influencing people. Though it may be desirable to keep essential production out of the reach of the Soviets, the supply effect today is less important than the influence effect. For those states that must export, we may provide them with a non-Soviet source of a livelihood and at the same time increase their dependence upon us. Trade may be more vital than ideology. In this respect, we have an important advantage over the Soviets, who wish to remain autarkic and are willing to enter into only the most limited trading arrangements with nations that they do not dominate.

We must be sure to use this advantage to its fullest. We must realize the inherent power potentialities of trade, which stand in stark contrast to the harmony assumptions of nineteenth-century theory. We must understand that a policy of economic autarky on our part is not consistent with a policy of world coalition. The economic counterpart of global defense, as I have previously observed, is global trade. There exists a continual danger that security be perverted to protectionist aims; we must resist such tendencies. Internationai trade has been referred to as "a peacefui means of economic penetration" and also as "a bloodless revolution." We must see to it that this power works in our own behalf by cementing together the Free World coalition, and, at the same time, we must look to our defenses and attempt to deny to the Soviet the opportunity for "bloodiess revolution."

BIOGRAPHIC SKETCH

Professor James R. Schlesinger

Professor Schlesinger received his B.A. degree in Economics from Harvard University in 1949, and his Ph.D. in Economics from there in 1955, and has since advised many governmental agencies on economic matters.

He was on leave from his position as Assistant Professor of Economics at the University of Virginia to act as Economic Consultant on the staff of the Naval War College for the 1957 fall term.