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Benefit: The Conditions under Which Free Trade Is
Beneficial
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By

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WHEN EXPORTS ARE A COST AND IMPORTS ARE A BENEFIT: THE
CONDITIONS UNDER WHICH FREE TRADE IS BENEFICIAL*

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*There is perhaps no public policy issue on which economists are more likely
to agree than on the desirability of free trade.*

[Yngve Ramstad, 1987, p. 6]

Proponents of what has come to be called globalization promote free trade as one important part of the solution to poverty, economic volatility, and inequality. The major institutional players on this side of the debate—the IMF, World Bank and World Trade Organization—all emphasize the role played by a free trade regime in addressing these issues.

Opponents of globalization take the opposite tack, arguing that free trade and financial integration have exacerbated poverty, inequality and market volatility. In Seattle, Quebec City, and in various venues throughout the world, anti-globalizationists have taken their criticism into the streets with a vigorous display of anti-corporate, anti-WTO sentiment: “Fair Trade not Free Trade!”

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The problem, however, is that opponents have found it difficult to mount a sound attack on free trade. The theoretical defense of this doctrine is highly developed, is internally consistent within its own context, and it speaks eloquently to the various watchwords of the modern era—efficiency, growth, poverty-reduction, etc. Opponents have mainly nibbled at the edges of the argument rather than attacking it at its center. In so doing, they have raised issues such as the discrepancy between market prices and the true social costs of production; differences in the income elasticity of demand for developed and underdeveloped countries exports; Heckscher-Ohlin effects leading to greater income inequalities within countries; market failures, etc. (Hahnel, 1999; Gomoroy and Baumol, 2000).

The purpose of this essay is twofold. First, we explain why the debate on the merits of free trade has not produced a definitive statement as to the supposed benefits associated with the doctrine. Here, we are inspired by Ramstad, who argued that, “for lack of a coherent alternative to the framework provided by mainstream economic theory, opposition to the policy of free trade has been supported by little more than ad hoc arguments” (1987, p. 26). Our objective is to specify an alternative framework from which a sound theoretical attack against free trade can be launched. Specifically, we propose Keynes’ monetary production framework, which accords with the actual economic relations of a modern capitalist economy. Within the context of this framework, it becomes clear that the *intuition* of the anti-free trade adherents is correct. Having said that, our goal is not to defend import quotas or tariffs or to otherwise restrict the free flow of trade. Nor are we concerned with strategies designed to promote

financial support. Bell thanks the Center for Full Employment and Price Stability. The

balanced trade. Instead, we specify the institutional prerequisites that would allow the benefits of free trade to be discovered.

In a previous paper, we examined the necessary conditions that had to be satisfied if money were to arise as an economic institution. (Bell and Henry, 2001). In the course of our argument we touched on the distinction between exchange-based views and monetary or debt-based views. Here, we more carefully examine the neoclassical foundation of exchange that leads to the equating of exchange with trade, and contrast this view with that of theorists who examine the specific workings of a monetary economy where exchange takes on a quite different role and generates quite different results than those predicted by the neoclassical theory. Essentially, there is a difference between trade and exchange, and while all exchange is a form of trade, not all trade is exchange.

Trade and Exchange in the Neoclassical Framework

The standard, textbook argument on the benefits of free trade follows from a particular view of the economy that is first found in the work of Jean-Baptiste Say (though Adam Smith is usually cited as the point of departure for the free trade position). Say expressed his basic postulate not as “supply creates its own demand” (attributed to James Mill), but in more trenchant terms, maintaining that “. . . products are always bought ultimately with products” (Say, 1827 [1803], 106). This statement represents a

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certain view of the exchange relations of a market economy and gives rise to what would eventually become neoclassical economic theory.¹

Imagine a hypothetical peasant, petty-producing economy in which all are small property owners. Since petty producers were not jack's-of-all-trades, they specialized in the production of a particular item, which they trucked to the local trading venue for the purpose of conducting trade. In Say's hypothetical peasant economy, the output produced through specialization enabled the varied wants of individual producers to be satisfied through the process of barter. According to the textbook story, barter transactions were conducted in markets, where, say, iron was traded for corn, so that the demand for corn was determined by the amount of iron supplied. In an n -market economy, all products trade for all other products and aggregate demand is determined by aggregate supply. Disequilibrium relations, such as excess demand or excess supply in any particular market, would be resolved through changes in relative prices until all markets eventually clear.

At some point, producers/traders realize that barter imposes significant (transaction) costs and money is invented as a medium of exchange. However, the use of money opened up the possibility that selling and buying might be temporally separated.

Thus, as Mill argued:

Although he who sells, really sells only to buy, he need not buy at the same moment when he sells; and he does not therefore necessarily add to the *immediate* demand for one commodity when he adds to the supply of another (1844, p. 70).

¹ For a fuller account of what follows, in particular the relation between Say's economy and his view of a just society, see Henry, 2003.

For example, the iron producer might decide to save a portion of his money income (instead of purchasing more corn). Within the neoclassical framework, problems arising from the mismatch of supply and demand are prevented by postulating a loanable funds market. Thus, an increase in savings would bring “the” rate of interest down just enough to stimulate capital production (in the corn industry) to the point where the additional saving would be exactly exhausted by the additional demand for new investment. In an international setting, this may require transferring those savings to foreign markets (international capital flows), but the equality of aggregate supply and demand would be ensured – internally, through domestic market forces, and externally, through the price-specie-flow mechanism.² Thus, as trade relations evolve into the international arena, the efficiency gains from trade are extended across national frontiers so that free trade is beneficial to all.

Full employment is a necessary feature of such an economy. Each petty producer determines how much effort to exert, and, thus, how much output to produce, based on a calculation of the costs of that effort relative to the quantity of consumption goods (income) his produce will command in trade (supply creates its own demand). A “lazy” producer will clearly enjoy a lower standard of living, but the decision to provide work-effort is an individually determined one. As each individual is an independent producer with access to her own means of production, there are no social or economic constraints determining the amount of labor-time one can provide. Any perceived unemployment,

² Countries with trade deficits would experience gold outflows, which would reduce the domestic money supply and, hence, domestic prices. This, in turn, would stimulate foreign demand for domestically produced goods, which would reverse the flow of gold until equilibrium was reestablished at a position of balanced trade.

say a work-effort of only one-hour per day, is purely “voluntary” and is determined solely by the cost-benefit calculation of the producer.

The framework that captures the neoclassical gain-from-trade view of the economy is $C - C'$, where C and C' represent produced goods with different use values—iron and corn. When money is introduced, the relationship is modified to $C - M - C'$. No fundamental change occurs; money simply facilitates the exchange (trading) process. As the purpose of production is to satisfy consumption, no general overproduction is possible. As long as the use value contained in the product is deemed satisfactory from a consumer’s perspective, buyers will always be found, though prices may have to adjust to allow all output to eventually be exchanged.

The benefits of free trade are invariably illustrated by comparing a hypothetical nation’s well being pre- and post-trade. Internally, a nation maximizes its well being (i.e. its output) by producing somewhere along its Production Possibilities Curve (PPC). Resources are fully utilized at every point along the PPC and underutilized at every point below it. As long as at least one country (in a two-country framework) has a comparative advantage in the production of some good, both countries will benefit from specialization and trade, since each will reach a point lying beyond its PPC (a point previously unattainable due to resource and technological constraints).

In this view, trade is equated with exchange. And if this view is accepted as the basis of the debate surrounding modern exchange relations, it is impossible, given the assumptions, to undermine the doctrine of free trade as beneficial. Free trade *will* promote output, *will* promote efficiency, *will* promote income growth and poverty reduction. Free trade *is* beneficial, and free trade detractors are imposing negative

consequences on those whom they claim to be defending—the poor in particular.

An Alternative Framework: Keynes' Monetary Production Economy

In a monetary (or capitalist) economy, the proper formulation expressing the exchange relationship is M-C-M'. In this framework, money, not goods of different use values, is the object of exchange. Production is undertaken on the belief that the quantity of money received at the end of the production-exchange process (M') will be greater than the amount of money advanced at the outset (M). Capitalists borrow to purchase inputs, which are used to produce output, which is sold to generate more money. If $M' > M$, debts can be cleared and the process repeated. As Keynes explains:

The distinction between a co-operative economy and an entrepreneur economy bears some relation to a pregnant observation made by Karl Marx. . . . He pointed out that the nature of production in the actual world is not, as economists seem often to suppose, a case of C-M-C'. . . . That may be the standpoint of the private consumer. But it is not the attitude of *business*, which is a case of M-C-M', i.e. of parting with money for commodity. . . in order to obtain more money (Keynes, 1979 [1933], p. 81; emphasis in original).

Thus, in a monetary economy, the economic process is *not* directed toward the production of products (use values) as in neoclassical theory. Rather, it is the production of profit that is of concern. This requires the exchange of commodities so that the potential income contained in the product can be realized in money form. The economic process starts with debt (money) advanced to labor and the owners of purchased inputs, prior to the creation of output. Use values are then created, but these are useless in themselves to capitalists (or entrepreneurs, in Keynes' terms). Use values must first be converted into money so that debts can be cleared; these can then be used to satisfy the physical requirements of consumption and further production (capital goods). In a very

perceptive analysis of *The General Theory*, Dudley Dillard observed: “Real goods appear to the individual producer as an artificial form of wealth until they are converted into money which appears as real wealth to the individual producer.” (Dillard, 1954, pp. 28-29).

As Keynes explained, producers acquire wealth by engaging in profitable investment opportunities. But the investment decision is not passive (i.e. investment spending does not increase passively with saving as is the case in the neoclassical framework), nor is demand for firms’ output assured as it is in the C-M-C’ framework. Indeed, Keynes emphasized the fact that investment decisions must be taken in the face of an unknowable future, where the profits that might ultimately be forthcoming cannot be known with any degree of certainty at the time the decision must be made. Thus, decisions to acquire additional capital reflect the state of long-term expectation. If individual investors are optimistic, their estimation of the prospective yield of the investment will reflect this optimism. Specifically, a favorable state of long-term expectation will be reflected in the discount rate that equates the present value of the prospective revenue stream with the supply price of the capital asset – i.e. the marginal efficiency of capital. As Keynes explained, investment will be forthcoming only when the marginal efficiency of capital – which reflects the degree of optimism – exceeds the current rate of interest. Importantly, these “calculations” are made in the face of genuine uncertainty:

[O]ur decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities (Keynes, 1964 [1936], p. 161).

This insight goes to the heart of Keynes' monetary theory of production, where both consumption and saving are positive functions of the level of current income; saving represents a leakage; there is no mechanism (e.g. loanable funds market) to equilibrate *ex ante* saving and *ex ante* investment; the rate of interest is determined by the interplay between the stock demand for money – reflected by the degree of liquidity preference – and its stock supply; investment depends on the relationship between the marginal efficiency of capital and the current rate of interest; and the rate of interest on money “plays a peculiar part in setting a limit to the level of employment” (ibid., p. 222).

Thus, even in a closed economy, a host of *purely psychological* variables – e.g. the marginal propensity to consume, the marginal efficiency of capital and the state of liquidity preference – are likely to take on values incompatible with full employment. If, for example, private sector confidence is shaken, liquidity preference may increase and the marginal efficiency of capital may fall. As interest rates rise – in response to increased liquidity preference – fewer investment projects will be undertaken – since the interest rate is rising *and* the marginal efficiency of capital is falling. Declining investment spending will reduce aggregate output and employment, and the situation will be exacerbated through the multiplier effect, which is driven by the marginal propensity to consume.

The problems inherent in the closed-economy, M-C-M' framework are not diminished by opening the economy to free trade,³ a fact that was well-understood by Keynes' contemporary, Abba P. Lerner:

³ Recall that in the C-M-C' framework trade increases national well being because nations are able to reach points lying outside their production possibilities curves.

We have examined the process by which full employment may be reached in a capitalist economy that is complete in itself – that is, with no foreign trade – if the amount of money is given and the rate of interest is permitted to adjust itself to it, equalizing the demand for money to hold with the amount of money available to be held. In examining this process we noted a number of points at which it is likely to be stalled. When we bring in the complications of foreign trade we find there are still other difficulties in the way of the automatic movement to and maintenance of full employment in an uncontrolled capitalist economy” (Lerner, 1970, pp. 369-70).

Thus, as imports represent another form of “leakage”, bringing in foreign trade compounds the problem of coordinating injections ($I + G + X$) with leakages ($S + T + M$). Moreover, since output and employment are the adjusting variables in the Keynesian framework, a trade deficit is likely to produce declining GDP and rising unemployment even with domestic balance (i.e. $I + G = S + T$).

Since the balance of trade is a determinant of national income (and, hence, employment) in this system, trade surpluses are, almost by definition, desirable. Thus, one hears arguments in favor of export led growth, competitive devaluation, protectionism, etc. Let us now turn to an examination of the conditions under which these arguments are warranted.

When Free Trade is Detrimental

In chapter twenty-three of *The General Theory*, Keynes considered the argument in favor of free trade. Although the Mercantilists had been preoccupied with the balance of trade “for some two hundred years”, Keynes believed that by the early 1900s, “almost all economic theorists have held that anxiety concerning such matters is absolutely

However, when there are unemployed resources in the home country, it makes no sense to specialize productive efforts and engage in international trade, since it would be just as easy to increase domestic well being by using home resources efficiently.

groundless except on a very short view” (1964 [1936], p. 333). Indeed, Keynes, having been trained by Marshall, admits to sharing the view of the free-trade economists:

So lately as 1923, as a faithful pupil of the classical school who did not at that time doubt what he had been taught and entertained on this matter no reserves at all . . . As for earlier mercantilist theory, no intelligible account was available; and we were brought up to believe that it was little better than nonsense (ibid., p. 334-5).

Having said that, Keynes goes on to elucidate “what now seems to me to be the element of truth in mercantilist doctrine” (ibid., p. 335). The purpose of this section is to consider this insight, which remains as relevant today as it was almost one hundred years ago.

First, let us consider, from Keynes’ perspective, the merits of the mercantilist doctrine. To see the argument through his eyes, we must remember the core of his own argument:

Given the social and political environment and the national characteristics which determine the propensity to consume, the well-being of a progressive state essentially depends, for the reasons we have already explained, on the sufficiency of [inducements to new investment] (ibid., p. 335).

Thus, when the range of profitable investment opportunities (i.e. projects on which the marginal efficiency of capital exceeds the current rate of interest) is diminished, prosperity will be undermined. Keynes rationalizes the mercantilist preoccupation with the balance of trade in the following way. Effective demand (ED) is determined by aggregate investment; aggregate investment (I) is the sum of home investment (I_H) and foreign investment (I_F); home investment is a negative function of the domestic rate of interest (i_D); foreign investment is determined by the favorable balance of trade (BOT); the domestic rate of interest (given the state of liquidity preference) is a negative function of the quantity of precious metals (S_{GOLD}); and the quantity of precious metals is a

positive function of the balance of trade (BOT). These functional relations are specified below:

$$\begin{aligned}ED &= f(I) \\ I &= I_H + I_F \\ I_F &= f(\text{BOT}) \\ I_H &= f(i_D) \\ i_D &= f(S_{\text{GOLD}}) \\ S_{\text{GOLD}} &= f(\text{BOT})\end{aligned}$$

Thus, a favorable balance of trade *directly* increases foreign investment and *indirectly* increases home investment, both of which increase effective demand. In contrast, an unfavorable balance of trade (i.e. a trade deficit) would lead to an outflow of gold, which would then reduce home *and* foreign investment and, consequently, output and employment. Under a gold standard, then, it was perfectly rational for a nation to concern itself with the balance of trade.⁴

But, as Keynes recognized, these problems are not peculiar to nations operating under a gold standard; they emerge with *any* system of fixed exchange rates. Thus, under a conventional fixed peg or a currency board arrangement, countries face problems nearly identical to those faced by nations operating under a gold standard.⁵ To see this, let us turn to an examination of the problems faced by nations operating modern fixed exchange rate systems.

Modern Mercantilism and the Rate of Interest

⁴ Having pointed out the *political* and *economic* rationale for policies designed to promote a favorable balance of trade, Keynes was careful to point out the *practical* limitations of such policies. These limitations, which derive from the potential impact on the wage-unit and the possibility of capital flight, are not here germane. Interested readers can consult *The General Theory* (1964 [1936], pp. 336-7).

⁵ Today, forty-four countries operate conventional fixed pegs and eight operate currency boards (Krugman, Paul and Maurice Obstfeld, 2003, p.483).

Under an ordinary fixed exchange rate system, the central bank must intervene to defend the official exchange rate. In defending the peg, the central bank may be forced to buy or sell *large* quantities of foreign assets. Under a currency board arrangement, no such large-scale intervention is required; the currency board simply pledges to convert the domestic currency and the reserve currency into one another at the official (fixed) rate.⁶ However, both exchange rate systems bear important similarities to their ancient predecessor – the gold standard – and, subsequently, carry similar pitfalls.

Let us illustrate the argument by examining the mechanics under each type of fixed exchange rate system, taking the conventional fixed exchange rate system first.⁷ Currently, Malaysia pegs the value of the domestic currency, the Malaysian dollar, to the US dollar.⁸ Marginal holders of *any* Malaysian dollar (M\$) bank deposit at any Malaysian bank can:

(1) hold non-interest-bearing M\$ clearing balances at the central bank

OR

(2) exchange these non-interest-bearing M\$ clearing balances for:
(a) an interest-bearing debt instrument issued by the Malaysian government
(b) US dollars at the official rate of exchange at the central bank

As banks earn no interest on M\$ clearing balances, they will ordinarily prefer to economize on these holdings. This means that they will convert undesired clearing balances to domestic bonds or US dollars. The choice will depend, in practice, on the

⁶ Currency boards are usually (legally) required to hold enough foreign reserves to *fully* back the domestic monetary base (i.e. 100 percent reserve backing). This is supposed to enhance the credibility of the peg and discourage speculative attacks.

⁷ The illustrations are based on Mosler's (1998) approach.

⁸ Most countries operating fixed exchange rate systems still peg to the US dollar, however, since January 1, 1999, many countries have chosen to peg their currencies to the Euro.

expected rates of return on M\$ versus US\$ assets. If there is a widespread preference for dollar-denominated assets, holders of Malaysian dollar clearing balances will predominantly prefer option 2(b). In satisfying the demand for US dollars, the central bank will lose US dollar reserves.

Obviously, the central bank cannot tolerate a substantial loss of foreign exchange, because it may undermine investors' confidence in the bank's ability to defend the peg.⁹ Thus, to stave off the outflow of US dollars, option 2(a) must be made more appealing. This is accomplished by paying higher interest rates on Malaysian government bonds. Under a conventional fixed exchange rate system, the domestic interest rate becomes a positive function of the demand for the reserve currency (relative to its supply). In other words, it responds *endogenously* to the conversion of domestic clearing balances to the reserve currency.

Comparing the conventional peg to the gold standard, we discover that an outflow of the reserve asset (whether gold or US\$) leads to a rise in domestic rates, which can lead to all sorts of domestic problems (e.g. rising debt-service burdens, banking crises, declining investment, unemployment, etc.).¹⁰ Clearly, then, there are reasons to suspect that nations operating conventional pegs would prefer a trade surplus to a trade deficit. By running a balance of payments surplus, the country's net holding of foreign reserves

⁹ A loss of confidence in the central bank's ability to defend the peg can lead to a speculative attack on the Malaysian dollar.

¹⁰ As an example of how bad things can get, consider the case of Russia, which used to peg its currency to the US dollar. In the late 1990s, to stave off a massive conversion of ruble balances to US\$, interest rates on GKO's rose to roughly 150%. Soon after, the Russian government suspended the peg and adopted a floating exchange rate. (Mosler, 1998).

is increasing. Thus, preoccupation with the balance of trade is as rational for a country on a conventional peg as it was for a nation operating under the gold standard.

We now turn to the mechanics of the currency board. In essence, a currency board is a fixed exchange rate with a twist. The twist (usually) involves 100 percent backing of the domestic currency. In other words, the Currency Board is usually required (by law) to hold enough of the foreign reserve currency to convert the entire domestic monetary base.¹¹ Fully backing the monetary base is supposed to discourage market participants from launching a speculative attack against the domestic currency. Below, we illustrate the mechanics of the Bulgarian currency board.

Currently, the Hong Kong government fixes the value of its currency, the Hong Kong dollar (HK\$), to the US dollar. The convertible monetary base exists as cash (HK\$) and as HK\$ balances at the monetary authority's designated bank. The convertible base can be:

(1) held as cash or as a non-interest clearing balance

OR

(2) exchanged at the monetary authority for:

- (a) HK dollar-denominated government bonds issued by the HK government
- (b) US dollars at the official exchange rate

As before, undesired clearing balances will be converted into something else (2a or 2b).

Unlike before, conversion to government bonds will not eliminate the undesired balance.

This is because the Hong Kong government does not have an account with the monetary

¹¹ Domestic demand deposits are not convertible at the Board. If holders of domestic demand deposits wish to convert to the reserve currency, they must first convert their demand deposit to the domestic currency (i.e. cash). The Board only holds enough reserves to guarantee convertibility of the domestic base (i.e. the equivalent of M0 in the United States).

authority. Thus, bond sales will not reduce HK\$ clearing balances; instead, the balances simply move from one private bank to another.¹² Because of this, option 2(a) does not compete with option 2(b). As a result, clearing balances will be held willingly or they will be converted to US dollars (i.e. option (1) competes with option 2(b) only).

But, since a currency board typically holds only enough of the reserve currency to fully back the monetary base (M0 equivalent), a widespread desire to convert domestic demand deposits (e.g. M1 equivalent) to the reserve currency would require competition from 2(a) to stave off the conversion. Thus, in the presence of widespread conversion, extremely high interest rates are likely to result as the monetary authorities continue their orders to defend the peg. As Davidson explained:

A currency board is the modern equivalent of the gold standard where U.S. dollars are the ‘gold’. The gold standard worked only when there were no bandwagon effects. It always failed when there was a bandwagon effect for a fast exit (Davidson, 1999, fn 10).

Even when it has been possible for a country to harness the bandwagon effect (i.e. to avoid going off the peg) by offering higher and higher interest rates on domestic securities, the economy can be devastated in the process:

A currency board solution . . . is the equivalent to the blood letting prescribed by 17th century doctors to cure a fever. Enough blood loss can, of course, always reduce the fever but often at a terrible cost to the body of the patient. Similarly, a currency board may douse the flames of a currency crisis, but the result will be a moribund economy (ibid., p. 11).

The other big problem with a currency board arrangement is that it prevents the monetary authority from “increasing or decreasing the monetary base at its own

¹² Here, the accounting is somewhat tricky, so it helps to have a firm grasp of money and banking principles.

discretion” (Hanke and Schuler, 2000, p. 25).¹³ As Carbaugh notes:

A country that adopts a currency board thus puts its monetary policy on autopilot. It is as if the chairman of the Board of Governors of the Federal Reserve System were replaced by a personal computer. When the anchor currency flows in, the board issues more domestic currency and interest rates fall; when the anchor currency flows out, interest rates rise. The government sits back and watches, even if interest rates skyrocket and a recession ensues (Carbaugh, 2000, p. 489).

Again, this form of monetary system makes preoccupation with balance of trade a perfectly rational activity. Indeed, the easiest way for a nation operating under a currency board to increase its money supply is by running a current account surplus. Free trade, when it results in a trade deficit, may lead to a balance of payments crisis, a speculative attack, skyrocketing interest rates, and a bludgeoning of the domestic economy. Thus, in the modern-day world, the mercantilist doctrine finds its rationale under the monetary systems of conventional fixed exchange rates and currency board arrangements.

The Conditions Under Which Free Trade is Beneficial

Keynes realized that a nation would be forced to worry about its balance of trade whenever a fixed exchange rate *of any kind* (gold standard, conventional peg or a currency board) was adopted:

[T]he City of London gradually devised the most dangerous technique for the maintenance of equilibrium which can possibly be imagined, namely, the technique of bank rate coupled with a rigid parity of the foreign exchanges. For this meant that the objective of maintaining a domestic rate of interest consistent with full employment was wholly ruled out. . . instead of protecting the rate of interest, [London] sacrificed it to the operation of blind forces. . . one can . . . hope that in Great Britain the

¹³ This, of course, is only a “problem” for those who believe that the monetary authority should have discretion in this regard. For many economists – e.g. Hanke and Schuler – disempowering the monetary authority is an added benefit of the currency board arrangement.

technique of bank rate will never be used again to protect the foreign balance in conditions in which it is likely to cause unemployment at home (Keynes, 1964 [1936], p. 339).

In this section, we lay out the conditions under which a preoccupation with the balance of payments becomes unnecessary. We begin by recognizing that a nation cannot disregard its balance of payments when it adopts a fixed exchange rate of any kind. Consequently, flexible exchange rates are a *necessary* condition.

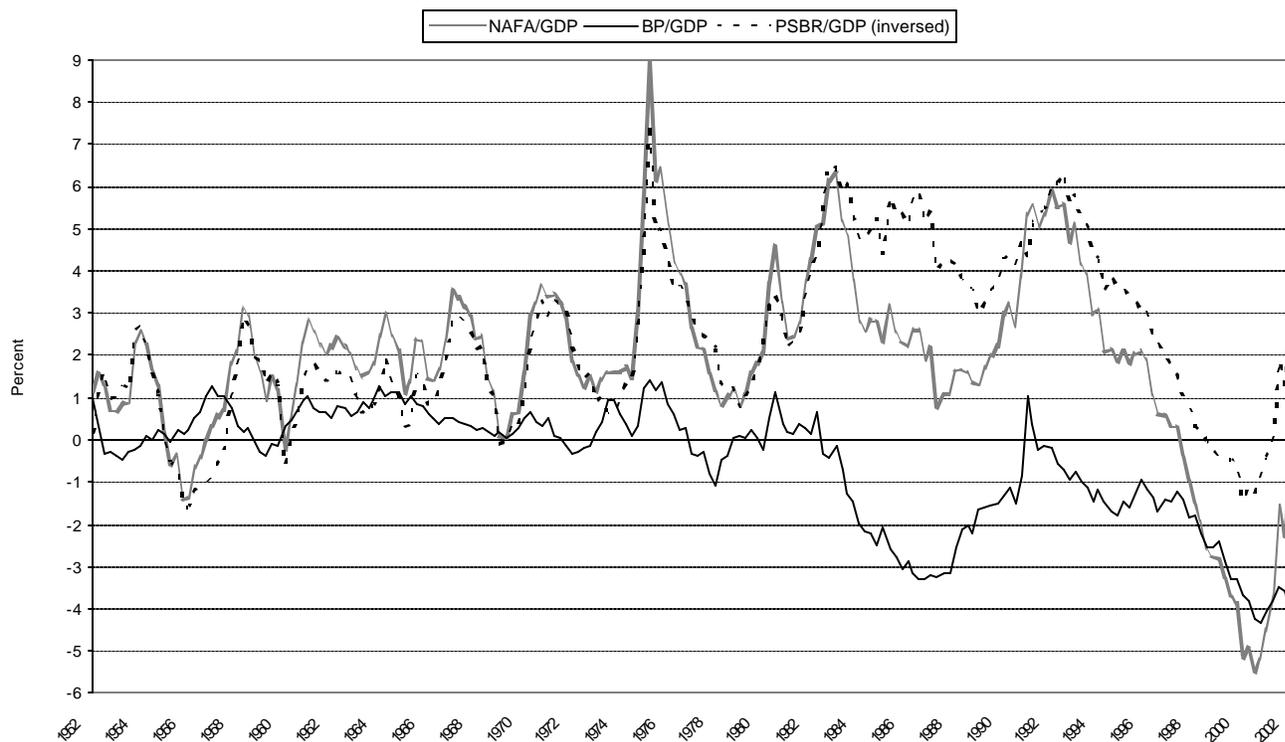
They are not *sufficient*, however, since the balance of payments still impacts private sector well being. Perhaps the easiest way to think about this is to think in accounting terms, relating the balance of payments to the private sector surplus. The balance sheet identity that defines these relations is given by:

$$\left(\begin{array}{c} \text{PrivateSector} \\ \text{Surplus} \end{array} \right) = \left(\begin{array}{c} \text{PublicSector} \\ \text{Deficit} \end{array} \right) + \left(\begin{array}{c} \text{BalanceOf} \\ \text{PaymentsSurplus} \end{array} \right)$$

This equation shows the (*ex post*) conditions under which the private sector will be in surplus or deficit. A private sector surplus is possible only if: (1) the public sector runs a deficit that exceeds any balance of payments deficit; (2) the balance of payments surplus is large enough to more than offset any public sector surplus; or (3) the public sector runs a deficit *and* the balance of payments is in surplus. If the public sector runs a surplus larger than the balance of payments surplus or its deficit is too small to offset the balance of payments deficit, the private sector *must* be in deficit.¹⁴ This, as Figure 1 shows, has been the situation in the United States since 1998.

¹⁴ Note that this implies nothing about causality. The conclusion follows merely from an *ex post* accounting identity.

Figure 1: Financial balance of the US (% of GDP)



Source: Wynne Godley calculations based on Flow of Funds data. NAFA=private sector net acquisition of financial assets (surplus); BP = balance of payments (surplus); PSBR = public sector borrowing requirement (or, general government deficit).

Here, one sees a sharp deterioration in the private sector's balance as the public sector surplus, together with the balance of payments deficit, combined to produce record-level private sector deficits from 1998-2002.¹⁵ Indeed, as Godley (1999) explained, the private sector's willingness to drastically increase its spending relative to its income enabled the U.S. to prosper for almost a decade, despite the fact that net exports were negative and fiscal policy was highly restrictive throughout most of the expansion.¹⁶

¹⁵ The public sector's balance is inverted so that surpluses appear in negative territory and deficits are shown in positive territory. This standard practice allows one to easily view the sum of the public sector deficit and the balance of payments surplus as the private sector surplus.

¹⁶ Godley (1999) explains that the stance of fiscal policy is considered neutral if the deficit is small and does not increase, as a share of GDP, through time. According to this definition, the government's fiscal position has been restrictive since 1992.

Unfortunately, as Godley explained, this scenario was necessarily unsustainable. By the start of 2000, the private sector had begun its inevitable retrenchment (Godley, 1999), attempting to bring its spending back in line with its income. But the private sector has not regained its surplus position, since public sector deficits remain too small to offset the relatively large balance of payments deficits the U.S. runs today. Now, this does not mean that the U.S. must resort to mercantilist tactics. Nor does it suggest that quotas, tariffs and other barriers to trade are needed. And clearly it would be silly to argue against trade of any kind, for as Keynes recognized, “[t]he advantages of the international division of labour are real and substantial” (1964 [1936], p. 338).

Institutionalists have thought about how best to strike a balance between the costs and benefits of free trade, and we believe they are on the right path. According to Wilber:

To soften the human suffering in those cases of massive dislocation, trade readjustment aid needs to be increased. Retraining programs for displaced workers, relocation allowances, and subsidies will help the impacted communities attract new businesses, in addition to helping to reduce human suffering and increase economic efficiency by providing access to new skills and encouraging mobility of resources. And, clearly, full employment is necessary to make these policies work” (Wilber, 1998, p. 470).

Posing a similar problem, Atkinson asks “[W]hat should the role of public authority be as the global economy continues to emerge?” (1999, p. 337). He concludes, following Commons, that the state should set “the minimum level below which the struggle for existence shall not be permitted” (ibid.). Summing up the institutionalist position, Adams says:

[I]nstitutionalists ... advocate ... cushioning the impact on genuinely affected groups through labor retraining and relocation, thereby helping to maintain full employment ... There must be a national program that can provide sufficient inducements and safeguards to affected people, firms and regions ... the affected individuals’ basic subsistence, health, and pension benefits must be provided for when industries yield ground to imports” (Adams, 1984, p. 278).

What this group of Institutionalists seems to support, then, is a federal program designed to cushion social and economic well being against the vagaries of free trade. The buffer stock employment programs, supported by Mosler (1998), Wray (1998, 1999), Forstater (1999) and Mitchell (1999) appear consistent with these calls.⁶ The Employer of Last Resort (ELR) program supported by Mosler, Wray and Forstater and the Buffer Stock Employment Program (BSE) put forward by Mitchell, would provide the kinds of safeguards recommended by Wilber, Atkinson and Adams.

Both programs require the federal government to fund a job guarantee program that would provide employment to anyone who is ready, willing and able to work but who is unable to secure a job in the private sector. In addition to protecting against job loss, both proposals also emphasize the importance of retraining for displaced workers. As an added advantage, supporters of the ELR plan have also recommended that the workers receive a pension, health care and childcare as part of the program.

As Lerner succinctly put it, “[t]he most serious foreign trade problems of the capitalist economy are connected with employment. (Lerner, 1970, pp. 369-70). That said, the benefits of free trade have been dampened the world over by the harsh effects of globalization, particularly those that accompany rising unemployment (i.e. widespread poverty, growing inequality and indebtedness.) To best cope with these problems, we need to establish a framework within which the benefits of free trade can be garnered without disregarding human rights in the process. To capitalize on the benefits of free trade, countries should adopt flexible exchange rates *and* implement a buffer stock employment program. With this framework in place, exports will become a cost and

imports will be a benefit. Only then will preoccupation with the balance of trade truly be unnecessary.

Concluding Remarks

Proponents of free trade invariably adopt the C-M-C' view of the economy first elaborated by Jean Baptiste Say. When Ricardo's principle of comparative advantage is added to this theoretical perspective, it is easy to demonstrate that free trade indeed promotes the advantages normally ascribed to this program. However, Say's (and Ricardo's) economy assumes full employment—the economy is already operating on the production possibilities curve. Any gains in efficiency resulting from free trade then allow an outward shift in the PPC, benefiting all trading partners (and their citizenry).

In an M-C-M' (i.e. capitalist) world, the economy (almost always) operates at some level below the production frontier, i.e., at some level of unemployment. In this context, a trade surplus means *reducing* the level of available consumption (exports must exceed imports) that is already less than an economy is technologically capable of producing. Economies running a trade deficit are advantaged given the logic of the export-import relationship, but, obviously, not all economies can be in a deficit position. At the world level, foreign trade must be a zero-sum game as to demand creation (exports must equal imports). Thus, if economies begin the trade process with some level of unemployment, there is nothing in the free trade argument to move them to their production frontier. Indeed, if we begin the argument from a position of unemployment, the tendency will be to move economies farther away from the frontier: surplus countries face no pressure to increase their production, while deficit countries will be under

pressure to bring their accounts into balance usually through domestic policies designed to reduce imports through reducing consumption: i.e. recessionary policies.

Hence, in the world we actually inhabit, free trade is not the panacea its proponents propagate. If we are to advance the economic interests of the bulk of the citizenry in a decent and humane fashion, we must promote a full employment policy domestically, and couple this with a flexible exchange rate regime internationally. With these institutions in place (on a global scale), exports become a cost and imports a benefit, and the conditions under which free trade is beneficial will have been established.

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