The Case for Free Trade

*by **Milton Friedman** and **Rose D. Friedman***

In international trade, Hoover fellow Charles Wolf Jr. argues above, deficits don't much matter. Here **Milton Friedman** and **Rose Friedman** discuss what does: freedom. A ringing statement of logic and principle.

It is often said that bad economic policy reflects disagreement among the experts; that if all economists gave the same advice, economic policy would be good. Economists often do disagree, but that has not been true with respect to international trade. Ever since Adam Smith there has been virtual unanimity among economists, whatever their ideological position on other issues, that international free trade is in the best interests of trading countries and of the world. Yet tariffs have been the rule. The only major exceptions are nearly a century of free trade in Great Britain after the repeal of the Corn Laws in 1846, thirty years of free trade in Japan after the Meiji Restoration, and free trade in Hong Kong under British rule. The United States had tariffs throughout the nineteenth century, and they were raised still higher in the twentieth century, especially by the Smoot-Hawley tariff bill of 1930, which some scholars regard as partly responsible for the severity of the subsequent depression. Tariffs have since been reduced by repeated international agreements, but they remain high, probably higher than in the nineteenth century, though the vast changes in the kinds of items entering international trade make a precise comparison impossible.

Today, as always, there is much support for tariffs--euphemistically labeled "protection," a good label for a bad cause. Producers of steel and steelworkers' unions press for restrictions on steel imports from Japan. Producers of TV sets and their workers lobby for "voluntary agreements" to limit imports of TV sets or components from Japan, Taiwan, or Hong Kong. Producers of textiles, shoes, cattle, sugar--they and myriad others complain about "unfair" competition from abroad and demand that government do something to "protect" them. Of course, no group makes its claims on the basis of naked self-interest. Every group speaks of the "general interest," of the need to preserve jobs or to promote national security. The need to strengthen the dollar vis-à-vis the deutsche mark or the yen has more recently joined the traditional rationalizations for restrictions on imports.

One voice that is hardly ever raised is the consumer's. That voice is drowned out in the cacophony of the "interested sophistry of merchants and manufacturers" and their employees. The result is a serious distortion of the issue. For example, the supporters of tariffs treat it as self evident that the creation of jobs is a desirable end, in and of itself, regardless of what the persons employed do. That is clearly wrong. If all we want are jobs, we can create any number--for example, have people dig holes and then fill them up again or perform other useless tasks. Work is sometimes its own reward. Mostly, however, it is the price we pay to get the things we want. Our real objective is not just jobs but productive jobs--jobs that will mean more goods and services to consume.

Another fallacy seldom contradicted is that exports are good, imports bad. The truth is very different. We cannot eat, wear, or enjoy the goods we send abroad. We eat bananas from Central America, wear Italian shoes, drive German automobiles, and enjoy programs we see on our Japanese TV sets. Our gain from foreign trade is what we import. Exports are the price we pay to get imports. As Adam Smith saw so clearly, the citizens of a nation benefit from getting as large a volume of imports as possible in return for its exports or, equivalently, from exporting as little as possible to pay for its imports.

The misleading terminology we use reflects these erroneous ideas. "Protection" really means exploiting the consumer. A "favorable balance of trade" really means exporting more than we import, sending abroad goods of greater total value than the goods we get from abroad. In your private household, you would surely prefer to pay less for more rather than the other way around, yet that would be termed an "unfavorable balance of payments" in foreign trade.

The argument in favor of tariffs that has the greatest emotional appeal to the public at large is the alleged need to protect the high standard of living of American workers from the "unfair" competition of workers in Japan or Korea or Hong Kong who are willing to work for a much lower wage. What is wrong with this argument? Don't we want to protect the high standard of living of our people?

The fallacy in this argument is the loose use of the terms "high" wage and "low" wage. What do high and low wages mean? American workers are paid in dollars; Japanese workers are paid in yen. How do we compare wages in dollars with wages in yen? How many yen equal a dollar? What determines the exchange rate?

Consider an extreme case. Suppose that, to begin with, 360 yen equal a dollar. At this exchange rate, the actual rate of exchange for many years, suppose that the Japanese can produce and sell everything for fewer dollars than we can in the United States--TV sets, automobiles, steel, and even soybeans, wheat, milk, and ice cream. If we had free international trade, we would try to buy all our goods from Japan. This would seem to be the extreme horror story of the kind depicted by the defenders of tariffs--we would be flooded with Japanese goods and could sell them nothing.

Before throwing up your hands in horror, carry the analysis one step further. How would we pay the Japanese? We would offer them dollar bills. What would they do with the dollar bills? We have assumed that at 360 yen to the dollar everything is cheaper in Japan, so there is nothing in the U.S. market that they would want to buy. If the Japanese exporters were willing to burn or bury the dollar bills, that would be wonderful for us. We would get all kinds of goods for green pieces of paper that we can produce in great abundance and very cheaply. We would have the most marvelous export industry conceivable.

Of course, the Japanese would not in fact sell us useful goods in order to get useless pieces of paper to bury or burn. Like us, they want to get something real in return for their work. If all goods were cheaper in Japan than in the United States at 360 yen to the dollar, the exporters would try to get rid of their dollars, would try to sell them for 360 yen to the dollar in order to buy the cheaper Japanese goods. But who would be willing to buy the dollars? What is true for the Japanese exporter is true for everyone in Japan. No one will be willing to give 360 yen in exchange for one dollar if 360 yen will buy more of everything in Japan than one dollar will buy in the United States. The exporters, on discovering that no one will buy their dollars at 360 yen, will offer to take fewer yen for a dollar. The price of the dollar in terms of the yen will go down--to 300 yen for a dollar or 250 yen or 200 yen. Put the other way around, it will take more and more dollars to buy a given number of Japanese yen. Japanese goods are priced in yen, so their price in dollars will go up. Conversely, U.S. goods are priced in dollars, so the more dollars the Japanese get for a given number of yen, the cheaper U.S. goods become to the Japanese in terms of yen.

The price of the dollar in terms of yen would fall, until, on the average, the dollar value of goods that the Japanese buy from the United States roughly equaled the dollar value of goods that the United States buys from Japan. At that price everybody who wanted to buy yen for dollars would find someone who was willing to sell him yen for dollars.

The actual situation is, of course, more complicated than this hypothetical example. Many nations, and not merely the United States and Japan, are engaged in trade, and the trade often takes roundabout directions. The Japanese may spend some of the dollars they earn in Brazil, the Brazilians in turn may spend those dollars in Germany, the Germans in the United States, and so on in endless complexity. However, the principle is the same. People, in whatever country, want dollars primarily to buy useful items, not to hoard, and there can be no balance of payments problem so long as the price of the dollar in terms of the yen or the deutsche mark or the franc is determined in a free market by voluntary transactions.

Why then all the furor about the "weakness" of the dollar? Why the repeated foreign exchange crises? The proximate reason is because foreign exchange rates have not been determined in a free market. Government central banks have intervened on a grand scale in order to influence the price of their currencies. In the process they have lost vast sums of their citizens' money (for the United States, close to two billion dollars from 1973 to early 1979). Even more important, they have prevented this important set of prices from performing its proper function. They have not been able to prevent the basic underlying economic forces from ultimately having their effect on exchange rates but have been able to maintain artificial exchange rates for substantial intervals. The effect has been to prevent gradual adjustment to the underlying forces. Small disturbances have accumulated into large ones, and ultimately there has been a major foreign exchange "crisis."

In all the voluminous literature of the past several centuries on free trade and protectionism, only three arguments have ever been advanced in favor of tariffs that even in principle may have some validity.

First is the national security argument--the argument that a thriving domestic steel industry, for example, is needed for defense. Although that argument is more often a rationalization for particular tariffs than a valid reason for them, it cannot be denied that on occasion it might justify the maintenance of otherwise uneconomical productive facilities. To go beyond this statement of possibility and establish in a specific case that a tariff or other trade restriction is justified in order to promote national security, it would be necessary to compare the cost of achieving the specific security objective in alternative ways and establish at least a prima facie case that a tariff is the least costly way. Such cost comparisons are seldom made in practice.

We could say to the rest of the world: We cannot force you to be free. But we believe in freedom and we intend to practice it.

The second is the "infant industry" argument advanced, for example, by Alexander Hamilton in his Report on Manufactures. There is, it is said, a potential industry that, if once established and assisted during its growing pains, could compete on equal terms in the world market. A temporary tariff is said to be justified in order to shelter the potential industry in its infancy and enable it to grow to maturity, when it can stand on its own feet. Even if the industry could compete successfully once established, that does not of itself justify an initial tariff. It is worthwhile for consumers to subsidize the industry initially--which is what they in effect do by levying a tariff--only if they will subsequently get back at least that subsidy in some other way, through prices lower than the world price or through some other advantages of having the industry. But in that case is a subsidy needed? Will it then not pay the original entrants into the industry to suffer initial losses in the expectation of being able to recoup them later? After all, most firms experience losses in their early years, when they are getting established. That is true if they enter a new industry or if they enter an existing one. Perhaps there may be some special reason why the original entrants cannot recoup their initial losses even though it may be worthwhile for the community at large to make the initial investment. But surely the presumption is the other way.

The infant industry argument is a smoke screen. The so-called infants never grow up. Once imposed, tariffs are seldom eliminated. Moreover, the argument is seldom used on behalf of true unborn infants that might conceivably be born and survive if given temporary protection; they have no spokesmen. It is used to justify tariffs for rather aged infants that can mount political pressure.

The third argument for tariffs that cannot be dismissed out of hand is the "beggar-thy-neighbor" argument. A country that is a major producer of a product, or that can join with a small number of other producers that together control a major share of production, may be able to take advantage of its monopoly position by raising the price of the product (the Organization of Petroleum Exporting Countries cartel is the obvious example). Instead of raising the price directly, the country can do so indirectly by imposing an export tax on the product--an export tariff. The benefit to itself will be less than the cost to others, but from the national point of view, there can be a gain. Similarly, a country that is the primary purchaser of a product--in economic jargon, has monopsony power--may be able to benefit by driving a hard bargain with the sellers and imposing an unduly low price on them. One way to do so is to impose a tariff on the import of the product. The net return to the seller is the price less the tariff, which is why this can be equivalent to buying at a lower price. In effect, the tariff is paid by the foreigners (we can think of no actual example). In practice this nationalistic approach is highly likely to promote retaliation by other countries. In addition, as for the infant industry argument, the actual political pressures tend to produce tariff structures that do not in fact take advantage of any monopoly or monopsony positions.

A fourth argument, one that was made by Alexander Hamilton and continues to be repeated down to the present, is that free trade would be fine if all other countries practiced free trade but that, so long as they do not, the United States cannot afford to. This argument has no validity whatsoever, either in principle or in practice. Other countries that impose restrictions on international trade do hurt us. But they also hurt themselves. Aside from the three cases just considered, if we impose restrictions in turn, we simply add to the harm to ourselves and also harm them as well. Competition in masochism and sadism is hardly a prescription for sensible international economic policy! Far from leading to a reduction in restrictions by other countries, this kind of retaliatory action simply leads to further restrictions.

We are a great nation, the leader of the world. It ill behooves us to require Hong Kong and Taiwan to impose export quotas on textiles to "protect" our textile industry at the expense of U.S. consumers and of Chinese workers in Hong Kong and Taiwan. We speak glowingly of the virtues of free trade, while we use our political and economic power to induce Japan to restrict exports of steel and TV sets. We should move unilaterally to free trade, not instantaneously but over a period of, say, five years, at a pace announced in advance.

Few measures that we could take would do more to promote the cause of freedom at home and abroad than complete free trade. Instead of making grants to foreign governments in the name of economic aid--thereby promoting socialism--while at the same time imposing restrictions on the products they produce--thereby hindering free enterprise--we could assume a consistent and principled stance. We could say to the rest of the world: We believe in freedom and intend to practice it. We cannot force you to be free. But we can offer full cooperation on equal terms to all. Our market is open to you without tariffs or other restrictions. Sell here what you can and wish to. Buy whatever you can and wish to. In that way cooperation among individuals can be worldwide and free.

Milton Friedman, recipient of the 1976 Nobel Memorial Prize for economic science, was a senior research fellow at the Hoover Institution from 1977 to 2006. He passed away on Nov. 16, 2006. He was also the Paul Snowden Russell Distinguished Service Professor Emeritus of Economics at the University of Chicago, where he taught from 1946 to 1976, and a member of the research staff of the National Bureau of Economic Research from 1937 to 1981.

Adapted from "The Tyranny of Controls" in *Free to Choose: A Personal Statement*, by Milton Friedman and Rose Friedman, published by Harcourt Brace Jovanovich, © 1980. To order, call 800-543-1918. Available from the Hoover Press is *The Essence of Friedman*, edited by Kurt R. Leube. To order, call 800-935-2882.
