ESSAYS IN INTERNATIONAL FINANCE

No. 5, Summer 1945

BILATERALISM AND THE FUTURE OF INTERNATIONAL TRADE

HOWARD S. ELLIS

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIAL INSTITUTIONS

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the fifth essay of a series on international trade and finance published by the International Finance Section of the Department of Economics and Social Institutions in Princeton University.

While the Section sponsors these essays it takes no further responsibility for the opinions therein expressed. The writers are free to develop their topics as they will, and their ideas may or may not be shared by the committee on publication of the Section or the members of the Department. The author of the present essay, on leave of absence from the University of California, is currently serving as Assistant Director in the Division of Research and Statistics of the Board of Governors of the Federal Reserve System. The views he expresses are, of course, not to be construed as representative of either of the organizations with which he is associated.

BILATERALISM AND THE FUTURE OF INTERNATIONAL TRADE

HOWARD S. ELLIS
University of California

I. INTRODUCTION

The chief peril to a large volume of free multilateral trade in the post-war world may be bilateralism, and the chief problem of international commercial and economic comity may be the effective curbing of this tendency. There are many devices by which government authority or private monopoly can interfere with the course which international trade would take if left to the free choice of individual producers and consumers. These range from the venerable method of protective tariffs to the newer and more versatile methods of under- or over-valued exchange rates, multiple (or discriminatory) exchange rates, direct quantitative control of imports, and sometimes of exports, through exchange control, quotas, clearing and compensation agreements, cartels, and finally, as a sort of culmination, state trading.

An examination of the operation of each of these methods of interference with private commodity and capital transactions will reveal that, as they have actually operated, the device most restrictive upon the volume of international exchange is bilateralism in its common forms of clearing and compensation. A further inquiry into the prospective post-war scene will reveal the multiplicity of situations which may induce or thrust countries into a policy of bilateralism.

II. LIMITS UPON THE RESTRICTIVENESS OF DEVICES OTHER THAN BILATERALISM

In a mechanical and static sense, in which the condition of *ceteris paribus* is strictly imposed, any one of the familiar devices for "regulating" trade can be carried to a point to produce the same quantitative limitation upon trade as any other.[1] However, as has been frequently observed, there exists a sharp contrast between protective tariffs and exchange rate manipulations, on the one hand, and direct quantitative regulations, such as exchange allocation, quotas, categoric prohibitions, and time-period embargoes, on the other. Interference by means of tariffs and authoritarian setting of exchange rates still permits readjustments in the price systems of both selling and buying countries. These

[1] *See* Kurt Häfner, "Zur Theorie der mengenmässigen Einfuhrregulierung," *Weltwirtschaftliches Archiv*, Vol. 40, No. 2, pp. 18-61, Vol. 41, No. 2, pp. 190-223.

work in the direction of permitting a larger flow of goods to hurdle the tariff or exchange rate obstacle than was possible upon the first imposition of the barrier. But all the direct quantitative limits, being absolute, permit no such adjustment of the comparative price structures to offset them, even in part.

On the score of partial offset through price adjustments, bilateral arrangements lie somewhere between the extremes of quotas and tariffs. For while the condition of a 1 : 1 balance (or any other arbitrarily chosen ratio) imposed upon the mutual trade of the two countries persists as absolutely as a quantitative import or export quota, nevertheless the prices of individual commodities—whatever the ratio chosen—can still show a certain interdependence between the two economies.

But on other, institutional, grounds there are good reasons for believing that no device portends more restriction of international trade in the post-war setting than bilateral trade arrangements. This conclusion comes from a piecemeal analysis of the operation of each of the main trade-regulation devices.

1. *Under- and Over-valued Exchange Rates*

The most common reason for undervaluing national exchange rates has been the desire to defend or expand domestic employment by increasing exports and decreasing imports; and it may confidently be expected that the temptation to cut exchange rates below an equilibrium level will recur with countries experiencing cyclical or chronic balance-of-payments difficulties after the war. But the very fact that the gain in employment is in two respects temporary prevents it from exercising a *cumulative* downward effect upon international trade. Prices, and eventually wages, rise under the influence of the increased cost of imports, and this begins to eliminate the bonus to exports. But, in the second place, retaliation by other countries, particularly through devaluations, undermines the original export differential. Having experienced such a cycle, countries are more apt to resort to other devices than to launch upon the same course again.

Overvaluation of a country's exchange rate, under ordinarily valid assumptions as to elasticities of demand for exports and imports, secures more advantageous terms of trade than an equilibrium rate of exchange. But the cost of the favorable terms is a penalty upon exports; and, in countries short of totalitarianism, export interests are usually sufficiently vocal, and the adverse effect upon employment is sufficiently clear, to make an adherence to the overvaluing rates practically impossible. Thus, by the latter part of the 'thirties, nearly all countries with nominally overvalued rates were conducting their trade, in fact, at near-equilibrium rates concealed by a multitude of devices. The chances of *real* and persistent overvaluation are meager because of the political effectiveness of export interests. But it should not be overlooked

that the persistence of merely *nominal* overvaluation perpetuates exchange control, and the exchange control in turn is the prolific source of bilateral trading arrangements.

As long as it persists, *real* overvaluation, on the other hand, is attended by a shortage of other countries' exchange in the overvaluing country. This shortage typically gives rise to a resort to clearing and barter, which enable the country to command a certain volume of purchases abroad without monetary wherewithal, much as "book credit" permits a prospective private buyer without cash resources to obtain goods against his eventual payment "in kind." But once launched upon bilateral balancing for a fair share of its trade, a given country may find no single juncture at which its reserves of free foreign exchange seem to be strong enough to permit it to risk a return to multilateral free payments.

This may be true even if considerable progress has been made toward reducing the overvaluation by means of adjustments in the clearing rate. For these rates now appear to be an integral part of the whole clearing system: to abandon bilateral balancing seems to entail sacrificing also the rates which have rescued exports from the incubus of overvaluation. Thus the enduring drag upon the volume of international trade is less apt to be overvaluation than the bilateralism which it engenders.

2. *Multiple exchange rates*

Where the authorities controlling a country's foreign trade "charge what the traffic will bear" by exacting higher rates of exchange for the country's currency for some exports than for others, or carry discrimination still further by differentiating exchange rates not only by export category but *also* by buying country, we encounter the phenomenon of "multiple currencies" or "multiple exchange rates." While the practice is commoner for exports, it is by no means unknown for imports when the importing country dominates the world demand and in some fashion is able to isolate one set of sellers from others.

Though multiple exchange rates may on balance involve either under- or over-valuation of a country's currency, the primary purpose of the plurality of rates is less apt to be an artificial departure from exchange rate equilibrium than it is to be an artificial *raising of the country's equilibrium rate* by means of discrimination imposed upon foreign buyers or sellers. Underlying such discrimination there must, of course, be monopoly or at least downward inflexibility of prices. Perhaps a private monopoly already exists within the country and the central trade authority merely adds to it the discriminatory feature. But, if competitive firms supply the foreign market, the state must create the monopoly by fostering private cartels, or must itself monopolize sales for export, since otherwise competitive firms would be induced by the windfall profits to expand output and cut prices. Thus the additional income temporarily secured by differentiated exchange rates would disappear through competitive firms' quoting such domestic prices as would, when converted into terms of foreign currency, be uniform for all buyers.

The restriction imposed upon international trade by multiple currency or multiple rate practices is more severe than that which attends a uniform exchange rate which is above or below equilibrium. For, while overvaluation is apt to be *temporary* for the bulk of a country's trade, and undervaluation is *offset* to the degree to which foreign countries follow suit, neither is true of discriminating rates. One country proceeds to exploit the potential monopoly or monopsony discrimination for particular countries or for particular commodities, and then other countries emulate its example. Since, within the very widest limits, monopoly restriction in one direction can be added to monopoly restriction in another, the shrinkage of world trade proceeds cumulatively.

The success of discriminating monopoly or monopsony depends, however, in international trade as elsewhere, upon the isolation of foreign buyers or sellers into non-communicating markets. The very extent and diversity of world markets make the international field a more intractable subject for monopolization upon either the supply or demand side than a single country. International cartels have, of course, been able for longer or shorter periods to surmount these difficulties. But if we are concentrating attention upon what a *single country* can accomplish by means of differential exchange rates (chiefly upon its exports) it would be difficult to find cases of successful discrimination which depended solely upon that device. Actually the cutting of the market into non-communicating segments is the handiwork of *bilateral clearing or payment agreements,* and the multiple exchange rates simply exploit the monopoly power created by these devices. Cases in which multiple rates unsupported by a clearing system have rested simply upon a national monopoly or quasi-monopoly are indeed rare.

3. *Exchange control and quotas and the quantitative limitation of imports*

In the present context we look aside from the aspects of exchange control which are already treated under under- and over-valuing and multiple exchange rates, and concentrate attention upon the direct regulation of exports and imports. In this respect, exchange control can achieve much the same results as quotas except for those minor differences arising from the fact that exchange control operates indirectly through stipulation with respect to the means of payment in place of direct stipulations as to the physical quantities of imports or exports. The chief difference is that, if foreign sellers are willing and allowed to vend their wares on credit, imports in excess of a physical quota can

proceed unimpeded. But this can easily be eliminated by forbidding imports for which payment in foreign exchange has not already been officially approved.

In a setting of general depression and unemployment, there is no theoretical limit to the shrinkage of international trade which could be brought about by the various monetary instruments for restricting imports. For precisely this reason, unless the general prescription of the International Monetary Fund against the *monetary* devices of restriction and discrimination is complemented by a *commercial policy* agreement limiting the use of tariffs, quotas, preferential systems, bulk purchases, and the like, for similar ends, the Fund will be reduced to nugatory significance.

Economic welfare in the immediate post-war period will, however, be less jeopardized by impending unemployment for many important regions than by a scarcity of men, resources, and capital. For England, this is becoming increasingly apparent, as revealed by the London *Economist's* series of articles under the title of "A Policy for Wealth."[1] For rebuilding the nation's housing, rationalizing industry, increasing man-hour output, restoring and redirecting the export trades, England will require a selection rather than a reduction of imports. Indeed, in the aggregate, imports should increase if post-war planning for Britain actually succeeds. No extended argument should be necessary to show that the same situation should prevail for the large areas of Europe ravaged by war. Even the industrial aspirations of Latin America, China, and India need not betoken more than control of the character of imports, not a reduction of their volume. All arguments supporting the desirability of large foreign loans by the United States rest upon a similar supposition, that during the—conceivably quite protracted—transfer period, the outside world will on balance be importing. In these circumstances exchange control and quotas will be used to screen out sumptuary imports and imports which compete directly with the infant industries of the borrowers, but not those which contribute to restoration or the creation of industrial equipment. The regulation of imports may thus operate chiefly upon the composition of trade and only incidentally, or even negligibly, in a restrictive fashion.

4. *International Cartels and State Trading*

Private and government monopoly in international trade in the forms respectively of cartels and state trading and bulk purchasing by governments may conceivably lead to a restriction of the volume of exports and imports conformable to the theoretical maximization of profits under simple or discriminating monopoly. Future developments are conditioned by manifold political and economic factors.

[1] Under dates of August 19, 26, September 2, 9, 16, 30, October 7 and 14, 1944.

In the non-ferrous metals, chemicals, and electrical equipment fields, private cartels before the war undoubtedly substantially limited output and international trade.[1] Without direct government support, and indeed without inter-governmental collaboration, persistently successful cartels are not common in fields where producers are numerous; and thus there exists a certain "natural" limitation. But in oligopoly situations—where the number of producers is so small that each producer attempts to take account of the effect of his own price and output policies upon other producers—the outcome can be as restrictive as in simple monopoly. In many cases, cartels have gone sufficiently far in this direction as to constitute an importunate case for international intervention. In the past the intervention of national governments has frequently *supported* monopoly in the field of foreign trade. A multilateral convention would be less apt to fall victim to producer interests, though this risk would still be present.

In the post-war situation an equally serious threat to free and mutually profitable trade may come from state trading, which does not depend upon international action for its existence. While a really exhaustive monopoly of foreign trade does not exist outside of Soviet Russia, extreme forms of exchange control approached this condition, as in pre-war Germany. State trading in particular commodities was carried on in Switzerland, Norway, Czechoslovakia, and elsewhere. Bulk purchasing also can be made a powerful instrument of the state in foreign trade. Undoubtedly the war has given a strong impetus to nationalism and collectivism. Whether state trading, either explicit or concealed, exhaustive or partial, will flourish, and, if prevalent, whether it will be primarily an instrument of expansion or contraction, would seem to hinge primarily on whether effective organs of collective security and international economic collaboration will or will not be forthcoming after the war. But bilateralism, as will later appear, may flourish because of the peculiarities of the post-war situation even under a fair degree of international accord.

III. THE RESTRICTIVE EFFECTS OF BILATERALISM

1. *The Character of Bilateral Arrangements*

Just as with any one of the common restrictive devices which we have already reviewed, the aggregate influence of bilateralism will depend partly upon how widespread the practice will be. But in advance of assessing these possibilities after the war, we should look more closely into the character of bilateralism. A trading arrangement is bilateral when it involves an effort to achieve a predetermined quantitative ratio

[1] *See* T.N.E.C. Hearings, Part 25, *Cartels*; and Corwin D. Edwards, *Economic and Political Aspects of International Cartels*, Kilgore Committee, Monograph No. 1, Washington, 1944.

of the exports of country A to country B to the exports of country B to country A. Since the underlying price and exchange rate relationships are rarely such as actually to achieve the contemplated ratio, the definition must run in terms of the approximate goal. In many arrangements a 1 : 1 ratio has been the norm; but if interest payments, the amortization of outstanding obligations, or the making of new loans are incorporated into the agreement, a ratio deviating from simple equality may be contemplated with the export balance of the one country being applied to the payment of interest, old debts, or to the making of new loans.

The commonest devices for securing bilateral balance in the trade between two countries have been compensation and clearings. The former signifies a continuous and piecemeal equation of each parcel of exports from A by an equivalent value in exports from B; one-sided balances cannot then pile up nor, by the same token, can capital be transferred either as a loan or as a payment of existing claims. To obviate the nuisance and restriction upon trade involved for an exporter in ferreting out a suitable and available import from B for each parcel of exports from A,[1] clearing accounts have more frequently been used. All importers in B from A pay local currency into a common account, managed by an organ of the state; and all exporters in B to A receive payment from this common account as fast as funds become available through importation. If exports from A to B exceed exports from B to A, the difference piles up as a credit balance of country A: exporters in A then have to wait their turn to be paid from the lagging importations from B, or else look to other markets for their wares. Equilibrium can be produced: (1) by an inter-government arrangement as to the accumulated credit balance, for example, by application to outstanding obligations of A, funding B's debt, etc.; (2) by the government's direct intervention to limit the "excessive" exports from A to B or to stimulate exports from B to A; (3) by an arbitrary stopping of exports from A until B has paid off the balance; or (4) by a downward adjustment of the value of A's currency in terms of that of B until bilateral exports

[1] Compensation in international trade, while not improperly conceived of as barter, has a less restrictive influence upon trade than if the condition of barter were imposed on *all* transactions, including those purely domestic. If the latter still proceed under a free monetary exchange economy, the "double coincidence" required by a foreign barter transaction can potentially be satisfied by *any* good in the entire economy which can be had for money, for with the money the necessary good for export or import can be had. Of course the exporter must still go to some trouble in looking up the available commodity to match his own deal. Aside from this, however, the "double coincidence" means only that the transaction has to be settled, with no outstanding debts, with each "batch" of goods purchased or sold. Compensation thus differs from clearing, not in restricting still farther the range of commodities, but in precluding capital transfers. It should be noted, however, that in Germany a somewhat "impure" type of compensation required that the transaction produce a certain fraction of the sale price in free foreign exchange.

balance. These devices may be used to secure a simple 1:1 ratio or a ratio which transfers capital from A to B at a rate agreed upon by the contracting states.

2. *The Peculiar Restrictiveness of Bilateralism*

Whatever the ratio and *whatever* the method employed for enforcing it, clearings must, for the individual traders concerned, cause a reduction in the volume and profitability of foreign trade over what would be realized for them collectively with free multilateral trade. This follows from the fact that exporters in each country are no longer free to sell in the best market, but must now sell to those countries which buy enough from the home country to give the exporter an opportunity of receiving payment. On the import side, it is no longer the cheapest country but the country for which a clearing balance is available that now secures the trade. Under certain situations, particularly if clearing is accompanied by discriminatory exchange rates, a given (discriminating) *country* can increase the profitability of its foreign trade; but such a gain is always purchased at a higher cost to other countries and the net effect upon world trade must be restrictive.

Now there are several characteristics of bilateralism which cause it to be more restrictive in its practical operation than other interferences in foreign trade. In the first place, clearing is more or less inevitably contractive in that practical considerations usually counsel the complete omission of certain items from the clearing process; and, once adopted, clearings are usually the only legally sanctioned method of conducting trade. To prevent "padding" of the clearing with fictitious items, the partner country requires physical evidence of the particular export or import item; and since this is difficult for most *services* outside the tourist trade, they simply cease to be bought and sold across national borders. The same is true of the transit trade. International trade thus comes to be confined to visible exports and imports, with the possible—though by no means universal—exception of travel.

In the second place, the institution of clearing does not, like overvaluation, tend to "play out" because of the resort to the same device by other countries. Bilateralism, on the contrary, propagates and augments itself. When a particular country finds, for example, that because its trading partners have instituted clearing it is beginning to lose its inflow of free exchange for the purpose of commanding necessary raw materials, it may consider itself constrained to impose clearing upon those countries selling the raw materials. The process thus tends to work in a vicious spiral.

Furthermore, instead of contrasting logically with systems of under- or over-valued exchanges, clearing necessarily involves in the achieving of bilateral balance *ad hoc* exchange rates, with each partner, which have

no mutual consistency. The clearing country's exchange rates are necessarily over- or under-valued, depending upon the accident of the particular bilateral balance with its partner, *when compared with a unified rate in a free market*. By the same token, and upon the same basis of comparison, exchange rates under clearing are necessarily discriminatory between trading partners. To this inevitable sort of discrimination involved in clearings there may, of course, be added all sorts of outright discrimination through the rigging of rates of exchange, prices, availability of exports, and other such measures.

It is worthy of equal emphasis that the ratio of exports of A and B, adopted in a clearing or payments agreement, is always more or less arbitrary; and by consequence the volume and direction of not only current trade but also capital movements are more or less alien to the ordinary processes of economic maximization. Conceivably a given country could strive to incorporate into its clearing agreements such a ratio of trade with each partner that the "natural" or free multilateral balances would not be disturbed. Initially the import-export ratios of the clearings would scarcely distort trade at all; but with the lapse of time, unless these ratios were constantly revised, the system would lose contact with relative costs and prices in each pair of countries as well as with the clearing rate of exchange. Actually, however, such constant revision is foreign to the nature and even to the purpose of clearing, for if it were carried through with complete success the result would be the same as if free multilateral trade obtained; and thus clearings—even from the beginning—would lose their *raison d'être*.[1]

3. *Monopoly Power as the Motive of Bilateralism*

Let us therefore explore somewhat further the purposes which animate a resort to clearing. The purpose cannot be simply the *stabilization* of exchange rates, for this can be achieved through other features of exchange control without resort to the dividing of foreign trade into arbitrarily balanced segments. Nor can it be the mere *selection* of imports for purposes of national defense or consumer welfare, since this also can be imposed by import controls without bilateral balancing with each partner country. The same can be asserted with regard to the prevention of unwanted capital movements.

Since bilateralism *consists* in the breaking up of a country's external market into a series of isolated segments, we shall not go far astray if we discover its long-run *purpose* in this very isolation;[2] and isolation

[1] If clearings were divested of the contractive features which have been noted, and were used only to even off seasonal inequalities in trade, they might actually exercise a stabilizing and expansionary influence.

[2] In the short-run—for a few months, let us say—clearing permits some trade to go on where none would be possible because a complete shortage of foreign exchange exists. But after the emergency, the same basic factors which provide the possibility of

amongst groups of buyers or sellers gives to the other party to the market the power of monopoly or monopsony. The institution of monopoly or monopsony inevitably reduces the gain from trade derived by the party subjected to monopoly or monopsony exaction. Hence we may fairly deduce that bilateralism in its common forms of barter, clearing, and payment agreements are in general *imposed* by one country upon another. Though the second country may still derive substantial gains from the bilateral trade, what the first country derives, in *additional* gain from imposing bilateral balancing, the second country in general loses. Of course situations are imaginable in which both the first and second countries gain at the expense of third countries.

If we look back one step to discover the power which enables one country to impose bilateral trade arrangements upon another we find that the most common source has been the threat of a debtor country in current bilateral trade to stop payment unless conditions suitable to its purposes are met, amongst them repayment of outstanding obligations owed to the current-account debtor. It should be sharply emphasized that this power of the current-account debtor in a given bilateral relation cannot be brought to bear upon a particular country *unless* the bilateral trade of the two is separated from the rest of its trade. The current-account debtor in this particular relation may be a current-account creditor in relation to other countries; indeed, because of the long-run tendency of a country's aggregate imports to be balanced by exports, a country will typically have no current account debtor position to use as a club to secure repayment on old obligations. But, *even if its total balance of trade were passive*, this could not be brought to bear on the aggregate of its trading partners to secure the payment of old debts *unless* that country could deal with them collectively, and this is never the case. On the other hand, whether the total balance of trade for a given country is active or passive, *if it can isolate its dealings* with that country or those countries with which it does have a negative balance, it can threaten to stop current payments.

Aside from the adventitious position of the current-account debtor, there are other circumstances underlying the imposition of clearings. If a country knows that another is dependent upon it for new loans, it can secure bilateral agreements. Nearly every country enjoys comparative advantages in the production of certain commodities which may be very important for near neighbors, and which can be made the basis of a demand for bilateralism. A large country may constitute so large a

sales through clearings will also provide the possibility of sales for bills of exchange. As a permanent justification of clearing, the "no trade" alternative is fallacious for all countries taken together. But the argument does point to the necessity of international collaboration, since for one country in isolation the change to free payments may be difficult or impossible; *cf.* p. 3 above.

portion of another country's selling outlets as to induce the smaller nation to accede to a clearing convention and the acceptance of imports of inferior quality, or at higher prices, than would be elsewhere available. Finally, to these forms of economic pressure should be added the outright use of international power politics.

4. *How Bilateral Arrangements May Be Utilized*

Having once come by or strengthened a position of discriminating monopoly (in selling or buying) through dividing its trading partners into non-communicating groups, a country *may* employ its advantage more or less justifiably from the angle of international well-being. One of the more "legitimate" ends, which has already been mentioned, is the inducing or forcing of payment of outstanding claims. In a world-wide depression, however, this process of saddling current trade with the incubus of old debts cannot have had another effect than the progressive economic deterioration of debtor countries and the protracting of depression. Even aside from this pragmatic angle, the ethics of permitting the fortunate debtor-on-current-account countries to enforce their claims while export surplus countries, such as the United States, are impotent in the situation, are doubtfully justifiable.

Eloquent chapters have been written concerning the use of bilateral clearing and compensation to reduce the trading partner to a state of economic bondage. The history of German trade relations with the Balkans shows how discriminating exchange rates, discriminating prices, discriminatory availability of exports, sudden switching of purchases, forced loans through debt balances on the clearings, and the like, can be used not merely to turn the terms of trade adversely to other countries but to penetrate economically and politically into other nations' affairs, set fellow-countrymen against one another, and aggrandize the war potential of the master of bilateral trade.

IV. IMPENDING OCCASIONS FOR RESORT TO BILATERALISM

If bilateralism can be curbed, the opportunity for the use of under- and over-valuation and of multiple exchange practices will be narrowly limited—aside from state trading—to the not-too-frequent cases of "natural" monopoly and monopsony. In open multilateral trade, incorrect or non-equilibrating rates of exchange can much more easily be identified than in a welter of mutually inconsistent clearing rates; and in open multilateral trade the mere absence of the gratuitous discrimination inhering in the very nature of bilateral balancing makes the overt types of discrimination much easier to detect. Consequently, the successful operation of the International Monetary Fund, in establishing equilibrium exchange rates and in bringing to pass equilibrium in the balance of payments of one country by recommending measures which are not at the expense of other countries' balances of payments, is effectively conditioned by the suppression of bilateralism. But there may be many interests vested in this institution.

1. *The Position of England on Current Account*

Quite aside from the question of the liabilities arising from the war, England faces a protracted period of struggle to maintain the volume of imports and exports necessary even to a moderately high standard of living. The physical destruction of war will have to be made good; the rationalization of British industry will require heavy investments, perhaps partly from foreign sources; the "social budget" cannot be reduced without sacrificing human values; and meanwhile England has lost much of her foreign investments and many of her market connections. But no nation has more to gain from a flourishing and free multilateral trade than the United Kingdom, nor more to lose by all-round restrictionism. Consequently, the counsel given by some of her younger economists in the direction of recourse to the whole gamut of discriminatory trade devices must signify a clear abandonment of international cooperation.[1]

The pretext for such a course, that the United States cannot be relied upon to maintain full employment and hence that England cannot permit herself to be vulnerable to foreign depressions, cannot be maintained. Discriminating monopoly can indeed, under certain conditions, raise the total value of a country's exports, or, in the face of depression, partly offset the decline which would otherwise occur. The simple exclusion of imports by quotas or exchange control can likewise protect domestic employment. But all of this is achieved with an inevitable toll upon the longer-run economic prospects of the country.

If quotas, exchange control, and the like are employed simply as protectionist devices, the shrunken volume of imports debases English consumption standards, no matter how successful the full employment program at home; and it is difficult to see any necessity for making those policies dependent upon a reduction of imports.

On the other hand, if discriminating rates and prices or clearings are successfully employed to sustain or force an increase in the value of exports, retaliatory measures abroad are almost certain to make the gain temporary. Finally, the distortions in the geographic distribution and commodity composition of trade resulting from bilateral clearing mean that even a temporary gain in volume of trade entails a long-run cost in profitability. The *volume* may continue at a deceptively satisfactory

[1] *See* E. F. Schumacher, *Export Policy and Full Employment,* Fabian Research Series, No. 77, London, 1943; Thomas Balogh, "The International Aspects of Full Employment," Ch. V in *The Economics of Full Employment,* Oxford University Institute of Statistics, London, 1944.

level; but the forced diversion from cheapest sources and best outlets lowers the *utility* of the foreign exchange of goods and produces more or less "concealed unemployment" in the domestic economy.

Thus the insulation of the British economy from foreign depressions by protectionist or beggar-my-neighbor policies can at best secure short-lived advantages entailed by long-run drawbacks. Needless to say, the same argument applies to the United States and our own unemployment.

2. *The Empire Blocked Balances*

With regard specifically, however, to the vast accumulation of blocked balances owed to her dependencies, particularly to India, England is victim of a recurrence of the old "war debts problem" with heightened intensity. Service and amortization can be provided only by reduced imports or increased exports. But the rehabilitation of her economy and the political necessity of maintaining living standards of the masses forbid a reduction of imports; and British exports may encounter strong competition from the United States, from Western Europe, and perhaps, over a longer term, also from Russia and other newly industrialized countries. In this dilemma it is not unnatural that the thinking of some groups should turn toward bilateralism as a device for insuring that payment for imports into the British Isles can be made in the products of British industry without sacrifice of the terms of trade.

A sound case can indeed be made for exchange control (but *not* bilateralism) to govern capital movements and to concentrate imports for a transitional period upon articles of mass consumption and industrial reconstruction. There is, furthermore, reason for making a certain fraction of the service and amortization of sterling blocked balances available only for purchases in England, thus entailing concessions by the creditors as to price or quality as a *quid pro quo* for the gradual unfreezing of the debt, and the payment of the remaining fraction of the sums in free exchange.

It would be possible to devise a scheme by which the annual rate of amortization of blocked balances, beginning at a modest level to allow for England's limited capacity to export immediately after the war, would rise the more rapidly the greater the concession made by the particular creditor country as to total principal eventually to be paid. Depending upon the same concession, the schedule could also embrace progression as the fraction of the annual amortization to be paid in free foreign exchange compared to the fraction paid in sterling for use only in the purchase of *British* exports. This scheme would imply the funding of all blocked balances not involved in the first year's payments.

Once the debt payments were thus by a compromise solution put upon a permanent plan, and adjusted to Britain's capacity to pay, there would be no occasion for her to resort to bilateral clearings in order to force concessions of like character. Thus the world would be spared that purely gratuitous restriction of current trade, for the sake of payments on old debts, which characterized the Great Depression. If, by an offer of mediation, the United States government could contribute to the adjustment of the Empire blocked-balance problem, it would have made a contribution to peaceful economic intercourse in the future comparable in importance to its role in the international monetary and banking proposals.

3. *The Transfer of Reparations*

In addition to the general pressure to expand exports and the special circumstance of the British blocked balances, another element of the post-war situation which may throw international trade into bilateral channels is the collection of reparations. The statement and actual taking of reparations "in kind" enjoys a vogue nowadays which can only be explained as a delusion. It would lead too far afield to argue this in all its aspects, but the matter is relevant to the present theme.

The only absolute assurance that reparations will be raised and transferred is direct occupation and economic control of the paying country. Plans of the United Nations apparently contemplate such a program for Germany. But the occupation of an enemy country is both personally hazardous to the officers of the foreign powers and expensive, and the administration of an entire economy in which hostility and even sabotage may be encountered at every step may, after months or a few years, prove to be very discouraging. It is not inconceivable that those countries which aside from reparations would have an *import* balance from Germany—and throughout the two decades before the war this included the countries of Western Europe which, outside Russia, will be the chief reparation claimants—may suddenly hit upon a forced clearing with Germany as an easy, economical, and safe way of collecting reparations. This was the ubiquitous resort of these countries in the 'thirties to collect on debts outstanding at the time of introduction of German exchange control; a recurrence to the familiar device may again appear to be natural.

It is scarcely necessary to point out that such a procedure would be highly unjust, since it would force those reparation-claimant countries with favorable balances on current account with Germany either to collect by direct action—occupation and independent administration of the German economy—or to forsake the effort to realize upon their claims together. And this is true whether reparations are levied in kind or in money.

But it is necessary to add that, were bilateral clearings introduced as a method of forcing the transfer of reparations, the spread of bilateralism throughout Europe and the world would also follow. Every partner

country which found its inflow of foreign exchange cut off by the imposition of a clearing would, as in the 'thirties, seek to maintain its foreign trade by itself resorting to bilateral arrangements with its partners. The permeation of clearings throughout South America and elsewhere would then receive the same impetus from the outside, in addition to indigenous forces, as it experienced in the decade before the present war.

4. *Trade with Russia*

Unlike the situation during the Great Depression, when the chief complication presented by the foreign trade of the Soviet Union was the undercutting of capitalist economies through the dumping of agricultural exports, the difficulties presented in the period after the war will fall on the side of Russian imports. In many markets Russia may rapidly develop into so important a position on the demand side as to play a dominant role. Quite without subversive design, and as an altogether natural result of her buying position and the anxiety of each industrial nation to share largely in her imports, she may be willing and even induced by outsiders to conclude bilateral trade agreements. On her side this may appear as a legitimate bargaining tool; and, on the side of ambitious suppliers, an agreement to receive an equal amount of Russian goods for the privilege of an "assured" position in the imports of the Soviet Union may be attractive.

In fact, of course, whatever the originating motives on either side, bilateral clearing with Russia would deliver her trading partners—on the assumption that her imports in important categories bulk large in the total demand—into the hands of a powerful discriminating monopoly (or, more accurately, monopsony). The monopsony would rest upon the two facts of state trading and the importance of Russian imports; and the possibility of discriminations, as argued on pages 9 and 10 above, would rest upon a segmenting of the market through bilateral clearing. Instead of an "assured" position, the trading partners could be exploited as to the terms of trade and could be subject to various pressures through threats of switching to other sources of supply. Conversely it is not precluded that in particular instances the Soviet Union itself might be the object of these policies, which bilateralism always permits.

In the interest of the individual exporter *vis-à-vis* the Russian state trading monopoly, as well as the interest of Russia in a flourishing multilateral trade and in a peaceful world, it is essential that bilateralism should not develop in Russian trade. Most of the proposals brought forward to date are altogether impotent to prevent this outcome. A pledge on the side of the state trading monopoly to "be guided by commercial principles," while perhaps a legitimate part of trade agreements with

Russia, does nothing to realize this end; and, besides, discriminating monopsony cannot itself be denied the character of a "commercial principle." In some quarters implicit faith is put in global purchase commitments by Russia. Even if the problem were one of inducing Russia to purchase a certain minimum from the outside world, this proposal is naive in its assumption that Russian policy as to autarky *versus* articulation in the world economy could be influenced by mere minimum purchase agreements.

The only really effective method to protect the relatively defenseless trader in capitalistic countries confronting the Russian purchasing Leviathan would be an international agreement allocating Russian imports by countries. This suggestion has been made by Gerschenkron but in rather too modest and cautious a manner.[1] The device, as any system of market allocation resting upon relative shares in some base period, must suffer from a certain arbitrariness, and must be made subject to occasional revision. Yet it would effectively prevent the bargaining, through which exports of individual countries to Russia are determined, from becoming exclusively bilateral. Multilateral agreement, however painfully achieved, would work toward a genuinely multilateral pattern, and this would establish the best guarantee against discrimination either by or against the Soviet Union. In the course of time, with the progress of peaceful trade with the Soviet economy and with a gradual improvement of world trade in volume and in multilateral character, the governance of Russian trade by international agreement might be terminated.

5. *An Aggressive Export Policy on the Part of the United States*

The traditional and presumably permanent policy of the United States is opposed to discriminatory foreign trade practices in general and to exchange control and bilateral payment arrangements in particular. Yet we must be on guard lest our zeal in pressing exports and foreign loans for the sake of domestic employment lead directly or indirectly to these practices.

An effort to sustain exports at the $14.5 billion annual level achieved in our war effort could scarcely be successful without risk of this sort.[2] If we accept the Department of Commerce projection of imports, $6.3 billion annually, for a virtual full employment economy with a gross national product of $175 billion, the export balance to be covered by

[1] Alexander Gerschenkron, *Economic Relations with the U.S.S.R.*, The Committee on International Policy, New York, 1945, pp. 37-41.

[2] The testimony of Lauchlin Currie before a House subcommittee (see "Trade Policies after Victory," *Foreign Commerce Weekly*, October 28, 1944, pp. 3-7, 37-38) seems to imply as desirable, but does not explicitly espouse as the objective for the post-war period, the continuance of war-time levels of exports. Memoranda in various government agencies frequently take this level as the one implied by domestic full employment.

gold imports, gifts, and loans would run close to $8 billion each year. The Department of Commerce estimate of imports at full employment rests upon the assumption of unchanged tariffs. If the level of our tariffs were substantially lowered, our imports would undoubtedly expand. Sometimes it is argued that this expansion would be slight because of the inelasticity of demand by the United States for imported goods. A recent study by Hans Adler argues that, when imports are separated into dutiable and non-dutiable, tariffs appear to keep out those commodities which are most elastic with reference to price.[1] But even making allowance for this fact, it would be difficult to imagine an expansion of imports, through tariff reductions, by as much as a billion dollars, and hence exports at the 1944 level would still involve an export balance of $7 billion or more.

For a time after the war, perhaps two or three years, it would not be unreasonable if substantial export balances from this country were financed by gifts and by our taking gold. On humanitarian grounds and even for our own illuminated long-run self-interest we should give generously toward the relief and reconstruction of foreign countries devastated by war. Furthermore we can reasonably, for a limited time, provide exports for these purposes to countries able to make payment in gold from existing stocks or new production.

Over a longer term, however, neither gifts nor gold imports can be justified. Rather than demoralize foreign countries and international standards of solvency and probity by gifts or gifts concealed as loans, it would be preferable—if this were the only workable alternative—to expend the sums as domestic consumption or production subsidies to provide a national income necessary to full employment. And again—if this were the only workable alternative—it would be preferable to have recourse to these same domestic expenditures rather than secure employment through exports paid for only in gold. For in the latter event we should be acquiring an asset of complete worthlessness to ourselves, so that we might as well have made a gift; while the outside world as a whole is "worse off," relatively to the gift situation, by the amount of real resources devoted to gold production.

Gifts and gold are thus very shabby "solutions" of the problem of ordering our post-war international trade to maintain our domestic employment. Foreign loans by the United States are better, and they are just as much better as some yield is better than none. Given the present state of banker and popular psychology, it is probably most necessary to emphasize the extent to which American foreign loans can contribute to foreign productivity, to the profitable use of our capital and manpower, and to peaceful economic intercourse and progress for all nations. There can

[1] *See* J. Hans Adler, "United States Import Demand During the Inter-war Period," *American Economic Review*, June, 1945.

be little doubt that the extent of these beneficial capital movements would far exceed the amount of foreign loans on purely private initiative. It is not within the power of the private investor to judge the long-range productivity of investments within foreign economies where the success of the individual project is conditioned by its articulation in a very inclusive plan of national development. Nor can the private investor be expected to assume the added political risks of foreign investment without some offsetting guarantees by his own government.

Nevertheless it is also necessary to point to limits to a program of supporting our domestic employment through foreign loans—limits indeed which are additional to the requirement that even to be a *loan* the foreign use of the funds must provide for the service and amortization of the debt. An effort to maintain a "full employment" level of exports of $14.5 billion by loans of anything approaching $7 billion annually—ruling out the gifts and gold "solutions"—appears to be not only practically difficult to conceive in view of our previous maximum on foreign loans of $1.2 billion in 1928 but also dangerous from the viewpoint of the present analysis—the development of trade along bilateral and discriminatory lines.

The first danger lies within ourselves. As the volume of our new annual foreign lending increased, opposition to "spending" abroad against "spending" at home would increase, probably in a geometric progression. Parallel to this the demand would be more and more insistent that we assure the accrual of these expenditures to the demand for *our own* products by means of *tied loans.* In practical politics this would mean that loans would tend to depart farther from the *general* loan, contemplated, in the main, by the proposed International Development Bank, toward the tied loans made by the Export-Import Bank. Not only would multilateralism yield to bilateralism and a restrictive element be fastened upon trade; but also, intensifying the adverse effects, loans would shift from a broad developmental character to a narrow *ad hoc* type promising less in the aggregate and in the longer run.

The second danger would arise from the probable reaction of foreign countries to an enormous program of American foreign lending. To protect their domestic and foreign markets from the wave of American goods, the natural recourse would be to a heightening of tariffs, reducing of quotas, and the retaining or introducing of bilateral agreements. A mere government embargo upon our loans would afford a given country no immunity from the dislocations produced by our exports, since American loans elsewhere would increase the productive capacity of *other* countries and their export capacity.

The foregoing argument does not signify that universal disaster would attend an orderly development of capital-poor countries by means of American capital exports. On the contrary, this is a natural and mutually beneficial development which should be facilitated, as will be argued more fully presently. It does imply, however, that large American loans signify large American exports which in some products and for some areas will undercut the markets of other countries. The problem is one of adverse initial impact, adjustment, and eventual equilibrium. For this reason we cannot assume that immediately after the war the United States can switch its exports in undiminished volume from war to peace-time goods without adverse effects upon the export capacity and hence the economic viability of such a country as England. If, instead of loans of $7 billion, we were to export capital to a half or third of this magnitude, the strain of adjustment would be vastly diminished; our exports would then be absorbed into the productive apparatus of foreign economies without at the same time competing too severely with their output.

The achievement of full employment is a process of adjustment. Exports from the United States contribute to our employment, it is true. But, even if we finance our exports by loans, there is a point past which we are thrusting the adjustments necessary to our full employment upon the shoulders of other nations.

V. THE MEANS OF PREVENTING BILATERALISM

We have seen that bilateralism involves interferences with foreign trade which are not only particularly restrictive but also restrictive in ways which are purely gratuitous so far as concerns the legitimate ends of government regulation. We have seen also that very powerful forces will exist after the war tending to thrust trade into bilateral channels. What steps can be taken to prevent this unfortunate turn of events?

1. *Proscription of Bilateral Trade Agreements*

The legitimate purposes of exchange control, such as the prevention of capital flight, stabilization of exchange rates, and the selective control of imports, do not require bilateral clearing or barter arrangements. As an earlier section has shown, the real *raison d'être* of bilateralism is discriminating monopoly. Now there are not lacking apologists for bilateralism on precisely these grounds, the application invariably being made for the benefit of countries needing to develop or restore their industries. But this position cannot be defended. In the first place, if the economically weak are accorded the use of this weapon there is no dividing line in an array of nations according to their wealth or power at which it is possible to call a halt. In fact, the practice, once admitted, is bound to spread as it did in the 'thirties; and as soon as the relatively strong countries also resort to discriminatory monopoly, the weaker countries will find themselves in an *absolutely* weaker position than if this course had not been set. Their relative position is no better, and they share in a world trade which is now smaller.

Secondly, it is difficult or next to impossible for one country to withdraw from a system of clearings, for at no single juncture will it believe that, by "letting down the bars" to free multilateral trade, it can derive sufficient foreign exchange to meet its import needs. Even Austria, which over the years 1933-1935 managed to remove other elements of exchange control, could not divest herself of clearings.

For these reasons the International Monetary Fund proposed at Bretton Woods is deficient upon a crucial issue. As it now stands, the Fund does indeed pledge signatory countries not to "impose restrictions on the making of payments and transfers for current international transactions" (Art. VIII, Sec. 2, a) and not to "engage in any discriminatory currency arrangements or multiple currency practices" (Art. VIII, Sec. 3); and these presumably include bilateral clearings. But provision is made for a transition period of somewhat indeterminate length during which these practices are permitted; and there is no clause preventing a country from construing the exchange control permitted in Article VII, for purposes of rationing a scarce currency, so as to include also the use of bilateral clearings. Clearings should simply have been categorically proscribed as of the date when the Fund agreement would go into effect. Lacking such a clause in the Fund, there would be every reason for providing in a Multilateral Commercial Policy Agreement, which has an importance paramount with the monetary arrangement, that all clearings shall be terminated as of a definite date not many months after the signing of the pact. Bilateralism, like military armaments, is something which in the nature of the case cannot be abandoned by individual nations *seriatim*, but only in concert and simultaneously.

2. *Strengthening of Weak Balance-of-Payments Countries*

While the only way effectively to abolish the gratuitous restriction and the inevitable discrimination of bilateralism is to proscribe the practice, it would be folly to stop with a merely negative action. Clearings arise and persist not only from a desire to secure for a nation the adventitious gains of monopoly but also from desperation resting upon deep-seated economic difficulties.

One of these may be an improper rate of exchange—usually one too high for equilibrium in the balance of payments. The experience of the 'thirties, however, reveals that there are at least three circumstances which make it impossible to rely upon individual countries for the correction of improper rates. One is the perennial temptation to engage in the "exporting of unemployment" by reducing the foreign value of the country's currency below its true or equilibrium value. Another is the attending temptation for other countries damaged by this undercutting

to follow suit, whereas international equilibrium requires the correction of the original excessive devaluation. A third is reliance upon drastic devaluation in some cases where the elasticities of demand for exports and imports would indicate that no improvement in the balance of payments can be expected from minor exchange rate adjustment.[1] In all of these cases the *only* real guarantee against a purposeless devaluation cycle is an international monetary authority with power to veto inappropriate devaluation.

Complementing this veto, however, the authority should be able to bring pressure upon an individual country to make internal adjustments necessary to correct balance-of-payments disequilibrium. For the weak currency countries this will characteristically mean the curbing of inflationary price tendencies, resting perhaps upon inflationary fiscal or wage policies. For strong currency countries it will mean a checking of deflation, a lowering of import duties, or encouragement of long-term foreign loans. Pressure can be exerted, as proposed in the International Monetary Fund, through withholding use of the authority's capital resources or by expulsion from the multilateral monetary organization. At the same time, the short-term emergency credits of the authority provide a means of tiding over seasonal or transitional balance-of-payments difficulties and the losses of reserves which continue while corrective action is being taken.

But currency difficulties cannot be cured fundamentally on the basis of an insecure national economy. The experience of the Great Depression has left an indelible impression that for countries dependent upon one or perhaps two or three export staples a safe international position requires a diversification of the country's economy. During the years 1929-1933, over 50 per cent of the gold lost from monetary reserves throughout the world came from extra-European raw-material exporting countries, and a very large part of the remainder came from European countries in the same category. If bilateralism is to be avoided in the future, the United States must provide large amounts of capital for the industrialization of backward countries as well as for the rehabilitation and rationalization of industry in countries wasted by war. As indicated in an earlier paragraph, capital exports of $2 or $3 billion *per annum*—two or three times the magnitude of our largest outflow hitherto—could be expected as a part of a high-income economy in the United States, provided the political risks of foreign investment in the uncertain post-war world were assumed through guarantees by an international bank.

[1] As, for example, inelasticity of home demand for foreign goods and inelasticity (in both cases with respect to price) of foreign demand for home goods, except for drastic devaluations.

3. *Establishment of an International Trade Authority*

We have suggested that bilateral trading will present itself as a powerful but dangerous weapon—if the economic battle is to be fought out by each nation on its own—in the cases of Britain's export problem, her blocked balances, the collection of German reparations, and conducting of trade with Russia. To these should be added the universal desire of backward countries to "manage their economies" away from dependence upon raw-material exports. The temptation in these cases to resort to manipulation of foreign trade is particularly strong, since the more orthodox remedies such as borrowing from abroad may be regarded—whether rightly or wrongly—as fraught with the danger of foreign exploitation and even intervention.

Thus the dangers of bilateralism are very real in the post-war scene. To cope with these dangers a strong and concerted international effort will be necessary. It has been stressed throughout this paper that bilateralism is, in many respects, the most objectionable form of restraint placed on international trade. But to say this does not minimize the damage inflicted on foreign trade by other devices from the arsenal of protectionism and discrimination.

Quite the opposite is true. The struggle against bilateralism in international trade will only be successful if it is conducted as a part of a general attack upon restriction and discrimination. In a world where international trade remains in the fetters of high tariffs, low quotas, arbitrary exchange allocations, and monopolistic exploitation by international cartels, the eventual success of the struggle against bilateralism would be unlikely.

The proscription of bilateralism, it has been suggested, should be included therefore in a general international agreement on commercial policies; that is to say, in an agreement by which import quotas would be abolished, tariff rates radically reduced, restrictive practices of international cartels suppressed, and equality of trading opportunity restored by a general application of most-favored-nation treatment.

The final purpose, however, cannot be accomplished by a single conference or simply by one act of international agreement. The next, equally essential, step would be the initiation of an international trade organization. By transforming the words of the agreement into the reality of international trade such an organization could carry the struggle against bilateralism to a successful termination. It is probably impossible to prevent bilateral transactions altogether. But a strong international organization, acting in close cooperation with the International Monetary Fund, will help redeem the promise of Bretton Woods, the creation of a healthy and expanding system of non-discriminatory multilateral trade.