

RE-ESTABLISHING THE GROUNDS FOR FREE TRADE: THE (FORGOTTEN?)
ASSUMPTION OF FULL EMPLOYMENT IN MAINSTREAM THEORY *

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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]

[I]n the absence of full employment in all the international trading states, [orthodox trade theory becomes] largely irrelevant

[H.C. Coombs, cited in Turnell, 2002, p. 115]

[T]he most serious foreign trade problems of the capitalist economy are connected with employment.

[Abba Lerner, 1970, pp. 369-370]

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—various governments, including those of the U.S. and England, the IMF, World Bank and World Trade Organization—all emphasize the role played by a free trade regime in addressing these issues.

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

The problem, however, is that it has been difficult to mount a sound attack against the doctrine of free trade, which is highly developed, internally consistent and rhetorically efficacious in its defense of efficiency, growth and prosperity. For their part, economists have primarily attacked the doctrine at its periphery, objecting to: discrepancies between market prices and the true social costs of production, differences in the income elasticity of demand for developed and underdeveloped countries’ exports, ethical problems surrounding current trade arrangements, Heckscher-Ohlin effects that generate greater income inequalities within countries, etc. (DeMartino, 2000; Hahnel, 1999; Gomoroy and Baumol, 2000). Unfortunately, such technical criticisms probably do little to assist the lay person’s cause – bumper stickers bearing the inscription “Heckscher-Ohlin Effects Impoverish Workers” seem an unlikely candidate. And even some economists sympathetic to the general sentiment of the anti-free-traders have been frustrated by these technical critiques, suggesting that “opposition to the policy of free trade has been supported by little more than ad hoc arguments” (Ramstad, 1987, p. 26).

The purpose of this essay is fourfold. In the first part of the paper, we examine the case for free trade, revisiting the main assumptions that must be satisfied in order to generate the optimal outcomes predicted by orthodox trade theory. Here, we establish that the orthodox “gains-from-trade” conclusion can be demonstrated only in a (barter-based)

macro framework in which full employment is assumed and balance of payments equilibrium is achieved through price-specie-flow adjustments. Next, we distinguish the attempt to deal with trade in the context of a *real exchange economy* (orthodox) from theory that emphasizes a *monetary production economy* (institutional or post-Keynesian). The difference is crucial, for the benefits of free trade become much more elusive when one moves outside the economy described by mainstream economists and into the real world we all inhabit. We develop this point in the third part of the paper, focusing on Keynes's assertion that internal balance (i.e. full employment) and external balance (i.e. balance of payments equilibrium) are *incompatible* under any system of fixed exchange rates. In the final part of the paper we argue that the expansion of trade cannot be sustained without a concomitant expansion of aggregate demand. Thus, we maintain that an international commitment to full employment must accompany the free trade agenda.

Trade and Exchange in the Neoclassical Framework

In order to elucidate our argument, we must first explore the features of the neoclassical theory which lead to the conclusion that free trade generates optimal outcomes. This requires a bit of historical inquiry, specifically into the foundations developed initially by Jean-Baptiste Say, who explains clearly and succinctly why neoclassical theorists must support, in the main, a free trade regime.

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 certain view of the exchange relations in 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 jacks-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. 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. 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.

But this conclusion rests on two crucial assumptions: (1) there is full employment of all resources; (2) a monetary system based on commodity money ensures balance of payments equilibrium. This point cannot be sufficiently stressed. While often overlooked or soft-pedaled in modern accounts, early trade theorists clearly understood the necessity of these assumptions for their general theory to hold. For example, the noted trade theorist James Meade begins the second volume of his *magnum opus*, *The Theory of International Economic Policy* with the following statement:

In the first volume of this work we discussed the problems involved in reconciling domestic policies for the maintenance of full employment with the preservation of equilibrium in international balances of payments. Accordingly, throughout this volume we shall assume that economic resources are fully employed and that international balances of payment are in equilibrium (Meade, 1955, p. 3).

In Say's (and the neoclassicist's) world, 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, 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 $C - M - C'$, however 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. At the international level, a monetary system based on fixed exchange rates, together with simple price-specie flow arguments, ensures that no balance of trade nor of payments problems can exist.

Let us now examine the free trade argument in more familiar terms. In most modern texts, whether micro or macro, the benefits of free trade are introduced in an early chapter. Invariably, the argument is illustrated by comparing a hypothetical nation's well being pre- and post-trade. Internally, a nation is said to maximize 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. Points lying outside the PPC are said to be unattainable, given current access to resources and technological know-how. But, these points become attainable through specialization and trade, as long as at least one country (in a two-country framework) has a comparative advantage in the production of some good. When this is the case, countries will be able to move from points lying *along* their PPCs to points lying *beyond* them.

In order to determine whether trade will be beneficial, countries must first determine how much labor is required to produce one unit of a particular good. These unit labor requirements are then used to determine relative prices (i.e. opportunity costs), which ultimately reveal whether a country enjoys a comparative advantage in production. When a comparative advantage exists, countries will export goods that their labor produces relatively efficiently (i.e. where opportunity costs are lowest) and import those goods that their labor produces relatively inefficiently. In the end, each country improves its well-being, since the consumption possibilities in each nation are enlarged through trade. These ideas are straightforward and generally understood.

But in the context of this simple C-M-C' analysis, two crucial assumptions are routinely glossed over. The first concerns the utilization of domestic resources prior to trade. Here, nations must be *fully employing their productive resources before engaging*

in trade so that the opportunity cost of producing an additional unit of any good becomes non-zero. A non-zero opportunity cost is necessary in order to derive non-zero relative prices, which are used to determine comparative advantage. With unemployed resources, it is possible to produce more of a particular good without sacrificing any other good (i.e. the opportunity cost becomes zero), and the economic justification for free trade collapses.²

The second assumption concerns the role of money in international trade. Modern trade theory is rooted in Hume's ([1752] 1987) monetary theory, which is essentially the monetarist quantity theory of money. According to this doctrine, prices in a country change directly with changes in its money supply. As Hume explained, an increase in net exports would increase gold flows into the surplus country. Then, because of the assumed relation between money supply and prices, the prices of goods in that country would rise. These relative price adjustments would discourage exports and encourage imports, thereby automatically preventing any persistent trade imbalance.³ The price-specie-flow mechanism, which ensures that each country achieves balanced trade, remains the basis of much contemporary thinking on free trade.

Now, what is the problem with the above account? It is not that of internal consistency. Indeed, once full employment is assumed (within each trading nation), the orthodox gains-from-trade outcome *will* prevail, because specialization and trade *will*

² The importance of the full employment assumption was recognized by Robinson (1937), Kalecki (1946), Kaldor (1984), Harcourt (1994), Milberg (1994), Prasch (1996), Davidson (1997), Kregel (1998) and Turnell (2002).

³ As Turnell (2002) explains, “there were varying versions [of this process], most often separated by the degree to which adjustment was seen as automatic or not”, but all of the versions “had their core in the specie-flow model of the classical gold standard” (p. 119).

enlarge the consumption possibilities in all nations.⁴ Moreover, as long as the balance of payments is assumed to adjust, persistent trade imbalances are ruled out and balance of payments adjustments are assumed to take place along price-specie-flow lines. *The problem is that the economy described is not that of a capitalist economy* where, among other things, money matters. The individualized, non-monetary world of Say simply cannot capture the actual relations of a capitalist economy. In the absence of full employment – which is never assumed or automatically attained in a Keynesian framework – comparative advantage ceases to provide an *unambiguous* justification for free trade.

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 in 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

⁴ Technically, the theory of comparative advantage requires many additional assumptions, including: perfect competition (in goods and factor markets), constant returns to scale, identical tastes and technologies, the absence of externalities, perfect (i.e. costless) factor mobility within countries and fixed capital resources and technologies.

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).

Return to the neoclassical position. The economy posited is a real good economy in which hypothetical individual producers exchange only to secure items with different use values than they themselves produce. In such a world, money is essentially irrelevant in determining economic outcomes, and functions only as a medium of exchange to lubricate the otherwise clumsy barter process: goods are translated into goods. Full employment is guaranteed as suppliers will always face sufficient demand to allow their goods to clear the market (though price adjustments may be necessary for this outcome). In a Keynesian world, demand deficiencies may, and usually will, occur as the object of production is not to secure use values but money itself. Hence, a "realization crisis" (in

Marx's terms) develops where goods cannot be translated into money due to a deficiency in spending. Unemployment is normal; the economy operates below its production frontier.

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: (1) both consumption and saving are positive functions of the level of current income; (2) saving represents a leakage; (3) there is no mechanism (e.g. loanable funds market) to equilibrate *ex ante* saving and *ex ante* investment; (4) 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; (5) investment depends upon the relationship between the marginal efficiency of capital and the current rate of interest; and (6) 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,⁵ a fact that was well-understood both by Keynes and his contemporary, Abba P. Lerner:

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. $I + G = S + T$).

In this system, trade surpluses are desirable almost by definition, since the current account is a determinant of national income (and, hence, employment and profits). It now becomes understandable why capitalist economies tend to favor trade surpluses and why, from time to time, we observe heated arguments over trade issues that can lead to trade wars. 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.

⁵ 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. However, when there are unemployed resources in the home country, it makes no sense

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 groundless except on a very short view” (Keynes, 1964 [1936], p. 333). Keynes recalls sharing these anti-Mercantilist sentiments:

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 he later decided was “the element of truth in mercantilist doctrine” (ibid., p. 335). The purpose of this section is to examine this argument, 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

to specialize productive efforts and engage in international trade, since it would be just as

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:

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

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 and, thus, adhere to an anti-free trade regime.⁶

Keynes's crucial insight – one he could not have reached as a young Quantity Theorist – follows from his recognition that changes in the supply of base money (in the

easy to increase domestic well being by using home resources efficiently.

⁶ 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).

above case, gold reserves) have their primary impact on the rate of interest, rather than on the price level. This, of course, implies a breakdown of the price-specie-flow mechanism, meaning that relative price adjustments will not insulate the real economy from trade imbalances. Instead, balance of payments deficits will result in outflows of gold, which will *endogenously* increase interest rates and lower investment, output and employment. On this point Keynes was emphatic, arguing that commodity money systems were wholly incompatible with full employment in an M-C-M' world. He recognized, moreover, that these problems were not peculiar to nations operating under a gold standard; they would befall any nation operating under a system of fixed exchange rates.

Modern Mercantilism and the Rate of Interest

Today, the IMF frequently supports the adoption of conventional pegs and currency board arrangement (usually under the auspices that these measures will allow developing countries to stabilize their currencies), even as they insist that countries open their borders to free trade.⁷ And, as Keynes predicted, these nations face problems nearly identical to those faced by nations operating under a gold standard. To see this, let us turn to an examination of the problems faced by nations operating modern fixed exchange rate systems.

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

⁷ Today, forty-four countries operate conventional fixed pegs and eight operate currency boards (Paul Krugman and Maurice Obstfeld, 2003, p.483).

the domestic currency and the reserve currency into one another at the official (fixed) rate.⁸ 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.⁹ Currently, Malaysia pegs the value of the domestic currency, the Malaysian dollar, to the US dollar.¹⁰ Marginal holders of *any* Malaysian dollar (M\$) 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 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.

⁸ 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.

⁹ The illustrations are based on Mosler's (1998) approach.

¹⁰ 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.

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.¹¹ 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, i_D 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.).¹² 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 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

¹¹ A loss of confidence in the central bank's ability to defend the peg can lead to a speculative attack on the Malaysian dollar.

¹² 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).

hold enough of the foreign reserve currency to convert the entire domestic monetary base.¹³ 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 Hong Kong 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 authority. Thus, bond sales will not reduce HK\$ clearing balances; instead, the balances simply move from one private bank to another.¹⁴ 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).

¹³ 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).

¹⁴ Here, the accounting is somewhat tricky, so it helps to have a firm grasp of money and banking principles.

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 discretion” (Hanke and Schuler, 2000, p. 25).¹⁵ 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

¹⁵ 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.

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 domestic money supply is by running a current account surplus, hence acquiring more of the reserve currency. 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

We have argued above that free trade is not beneficial when a country must use its interest rate to protect a reserve asset such as gold or foreign currency. Under such an exchange rate system, control over the interest rate is sacrificed to market forces and the objective of promoting full employment through increased investment spending is lost.

Keynes made this point emphatically:

[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 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 (our emphasis; Keynes, 1964 [1936], p. 339).

In this section, we lay out the conditions under which free trade becomes desirable. 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. With flexible exchange rates, there are no reserve assets that must be protected through (endogenous) adjustments in the money rate of interest. Since the option to convert domestic to foreign currency does not exist, policymakers are not forced to raise interest rates to try to stave off large-scale efforts to convert to the reserve asset.¹⁶ Instead, flexible exchange rates enable governments to set (exogenously) interest rates, targeting high levels of domestic employment – because in the absence of full employment at home, the justification for trading abroad disappears.

Less preoccupied with the *theoretical* aspects of the free trade argument, numerous Institutionalists have raised concerns over the *practical* ways in which to best strike a balance between the costs and benefits of free trade. Charles Wilber, for example, opined that:

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” (our emphasis; Wilber, 1998, p. 470).

Glen Atkinson also tackled the problem of free trade, asking, “[W]hat should the role of public authority be as the global economy continues to emerge?” (1999, p. 337).

Following Commons, he concluded that the state should set “the minimum level below

¹⁶ For more on the endogeneity vs. exogeneity of the domestic interest rate, see Mosler 1998 and Wray 1998.

which the struggle for existence shall not be permitted” (ibid.). Finally, John Adams attempted to sum up the Institutionalist position on free trade, suggesting that:

[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” (our emphasis; Adams, 1984, p. 278).

Thus, Wilber, Atkinson and Adams each emphasize the need for federal programs to cushion social and economic well being against the vagaries of free trade. And, since unemployment is among the more serious vagaries of free trade, Wilber and Adams emphasize the importance of domestic full employment as part of any free trade solution.

Elsewhere in the Institutionalist literature, the problem of full employment has recently drawn significant attention. In reviewing this literature, it occurs to us that the buffer stock employment programs, supported by other contributors to the *Journal of Economic Issues* (e.g. Wray, 1998; Forstater, 1999; Wray 1998; and Mitchell, 1999) might provide a concrete way in which to defend the population against the most damaging effects of free trade. Specifically, the Employer of Last Resort (ELR) program supported by Wray and Forstater and the Buffer Stock Employment Program (BSE) put forward by Mitchell, could 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. These elements of the program could readily be extended to a more general notion of a “living wage” to accommodate the above proposal of Atkinson. Note that the ELR plan necessarily connotes an increase in aggregate demand, not in the “pump-priming” sense usually associated with the conventional view of the Keynesian argument, but direct job creation. Institute at the world level, this would go a long way to satisfy the condition that for trade to increase and the employment problems associated with current trade patterns be alleviated, demand will have to increase.

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. Clearly, programs such as the ELR *are not* a panacea for the problems of international trade itself. Rather, they are necessary to more effectively manage the problems caused by trade.

Remember, free trade is beneficial *in theory* only when nations first establish full employment at home. Since it is not possible to revert to a pre-trade world in order to satisfy the necessary conditions for comparative advantage, we must seek the benefits of free trade *in practice* by striving for full employment today. To capitalize on the benefits of free trade, countries should adopt flexible exchange rates *and* implement a buffer stock

employment program, a program that carries with it the additional benefit of increasing aggregate demand, a necessary condition for increasing world trade. With this framework in place, we can defend against the more damaging consequences of free trade – joblessness, poverty and increased inequality.

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.

As we discovered in our research, tying free trade to balance of payments and full employment issues is not novel. It is *precisely* the same program, based on the same theoretical framework, developed by Australian economists in a vain attempt to insulate that economy from the pressures imposed by a US-dominated “free” trade regime after World War II. The “employment approach,” promoted by Coombs, Giblin, Melville, and others, clearly recognized the practical dangers in merging the neoclassical theory of trade and Keynes’s theory of employment (Turnell, 20002, p. 113). The Australians attempted to organize several conferences on the need for governments to “energetically participate in the formulation of a *world* employment policy” if they were to adopt a free trade program (ibid., p.114, emphasis in original). They also recognized that the monetary regime pushed by the U.S., while not a formal return to the gold standard, was similar to our examples of modern currency boards and would jeopardize smaller economies in particular as they sought some degree of independent control over their domestic policies.

Interestingly, although the Australians tried to enlist Keynes in support of their attempts to force discussion of the issues we’ve raised, they were rebuffed (ibid., p. 115, ff.), but not because Keynes was in theoretical opposition to their ideas – how could he be? In the last two chapters of *The General Theory* Keynes himself specifically argued the Australian position. For Keynes, practical politics trumped economic theory: discussions surrounding full employment had to wait until the monetary issues of the

post-war world had been settled. And in these matters, the U.S. held the best cards. Indeed, even the U.K. had made a similar proposal to the U.S. in 1943, based on a recommendation by James Meade, Keynes's colleague at Cambridge (*ibid.*, p. 117). But U.S. economic interests dominated all these discussions, and the rest of the world had to accept the U.S. position or suffer the consequences.

Hence, in the world we actually inhabit, free trade is not the panacea its proponents claim. 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. Today's protestors should rally around a "Jobs First, Trade Second" or "Full Employment before Free Trade" agenda.

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