As We See It

> "Every individual endeavors to employ his capital so that its produce may be of greatest value. . .;And he is in this led by an INVISIBLE HAND. . . .By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it."
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> Adam Smith, *Wealth of Nations* (1776)

It is not a coincidence that in 1776 both Adam Smith's, the *Wealth of Nations* and what would one day be the world's wealthiest nation should have burst upon the global scene. Before Smith, the prevailing economic doctrine was mercantilism. The mercantilists identified a nation's wealth or well-being by its stock of precious metals. Accordingly, a country was encouraged to export more than it imported, since the net outflow of goods would be matched by an inflow of gold. To stimulate a trade surplus, mercantilists counseled tariffs and export subsidies.

In his book, Smith expressed his belief that the mercantilists incorrectly associated a nation's wealth with its stock of precious metals rather than with the array of goods available to the nation's citizens – that is, its standard of living. While the mercantilists advocated the use of tariffs to reduce imported goods, Smith counseled there are two strong, and ever-present, reasons against a protective tariff. The first reason, tariffs are ultimately paid not by foreign producers but by domestic consumers, to whom the costs are passed along. The second, protective tariffs insulate producers from foreign competition. This protection not only allows them to raise their prices, but also makes it less imperative for them to seek ways to cut costs and improve quality. Smith held that it is the inescapable necessity to innovate and cut costs that powers the great force of the *invisible hand* for the general good.

While the United States currently has more than 8,000 separate tariffs, with taxes on some imports exceeding 100%, this country has generally practiced free trade – at least freer trade than its competitors. However, in the not too distant past, the U. S. retreated from free trade and contributed to worldwide economic disaster – the 1930s depression. The apex of this withdrawal from free trade occurred in 1930 when President Hoover signed the greatest tariff increase in American history into law, the Smoot-Hawley Tariff Act, despite a petition signed by more than one thousand economists who predicted it would lead to disaster.

Having learned its lesson from the twenties and thirties, the U. S. led free trade efforts following World War II. For the most part, it abandoned the protectionism that cost it so dearly in the 1930s and led the way on tariff reductions by means of the General Agreement on Tariffs and Trade known as GATT. The result was a massive increase in world trade and, no coincidence, world prosperity.

Now, a spate of Asian currency devaluations has raised the specter of a reversal of the trend toward free trade. The devaluations result in lower prices for Asian exports. As these relatively cheap goods are imported by other countries, trade deficits occur which, in turn, slows short-term production in the recipient country. This can lead to retaliation in the form of protective tariffs. Action has already been taken by South America's Mercosur trade bloc, led by Brazil, which recently raised its tariffs some 30%.

The U. S. is not immune. A rising U. S. trade deficit, which is the likely result of the Asian efforts to export their way out of their economic problems, may bring increasing talk of protectionism. Congress has already refused to approve fast-track authority for the president to negotiate further free-trade agreements. This effort was led by Richard Gephardt – who plans to run for president – and may make this an issue during the primary and perhaps the next presidential campaign. Soon the U. S. Congress will debate further funding of the International Monetary Funds *bailout* package for Asia. This may lead to discussions of protectionism, also. Should the U. S., the world's largest and most influential economy, succumb to protectionism, it would be very detrimental to the future of worldwide economic growth. The financial markets will be watching.

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