

Book Reviews

The Theory and Practice of Commercial Policy: Departures from Unified Exchange Rates by Jagdish Bhagwati. International Finance Section, Department of Economics, Princeton University, 1968.

In this small volume, Bhagwati paints a broad canvas but is sparing in detail. He defines "unified exchange rates" to include not only the existence of a single rate of exchange applicable to all external transactions but also the absence of any taxes, subsidies, premia, quotas, or administered prices in both internal and external markets. In short, a "departure from unified exchange rates" is any policy or circumstance which departs from the conditions of the perfectly competitive model. Bhagwati writes in the neo-classical tradition. However, as the argument progresses, it is clear that he is concerned about policies of interference with external trade.

He begins by recalling certain fundamental propositions which follow from the competitive model: *i*) trade is always to be preferred to no trade; *ii*) productive efficiency will obtain; and *iii*) utility (in some sense) will be maximized. (He does not enumerate *all* of the "efficiencies" which follow from perfect competition, but this is not a defect because these matters are well known and are elaborated in the standard literature.) He then proceeds to examine the circumstances in which departures from unified exchange rates are justified. He concludes that such circumstances are rare. With respect to interference in external trade there are but three clear-cut cases: 1) the "terms of trade" or monopoly argument for protection, which includes the possibility of price discrimination; 2) tariffs for "bargaining" purposes (which makes sense only if the country concerned has some monopoly, *i.e.*, bargaining power); and 3) imposition of import quotas under the special circumstances in which this action will promote an inflow of private capital.

Bhagwati then proceeds to dispose of a variety of fallacious arguments for protection and this discussion is followed by a lengthy list of circumstances in which one could make out a logical case that protectionism may yield benefits to an economy. With respect to the latter, however, he concludes that protectionism (whatever the form) is a second-best or third-best solution; domestic tax-cum-subsidy policies are to be preferred to controls over external trade.

Examples include cases in which there is a divergence between private and social values, situations of external economies, market imperfections (natural or pre-existing), promotion of saving or investment, the infant-industry argument, diversification, alteration of the income distribution, self-sufficiency, non-economic objectives, and others. This review of the "state of the art" is useful.

The author then turns to the matter of practice. Although this is not an empirical study, he observes that protectionism, in one form or another, is rampant throughout the world. The international economy is shot through with multiple and discriminatory tariffs, trade subsidies, over-valued currencies, exchange control with multiple rates, and quantitative restrictions. Such practices are especially notable in the less developed countries of the world and must be a major source of economic waste. He cites the ultimate example of economic inefficiency, protectionism which leads to creation of industries which produce a "negative value added". In short, he notes the great disparity between theory and practice.

He finds the explanation for this anomalous behaviour in such things as a lack of faith in the efficacy of the price mechanism, a belief that foreign-exchange shortage is a bottleneck which cannot be removed because of zero or negative supply response of export earnings, and a misplaced emphasis on exchange-rate stability as an indicator of prestige and national dignity. He also cites the "absurd" lack of official patience with the subtleties of economic analysis and the indifference of policy-makers toward matters of economic efficiency.

While the lessons of economic theory are indeed honoured in the breach, it seems to this reviewer that there is more to it than irrationality or naivete. There is at least some room for misgivings about the applicability or appropriateness of the theory. With casual empiricism at least as valid as that indulged in by the author, it may be noted that every industrialized, highly developed country of the world has, during most of its modern history, practised widespread, discriminating, and probably inefficient protectionism. This is true whether the example is drawn from private-enterprise economies or from the socialist world. Also, there is a number of less developed countries which have suffered prolonged economic stagnation under conditions of essentially free trade. On the other hand, we observe that a number of countries have been notably unsuccessful in their efforts to "take off" into sustained growth despite a high degree of protection. Nevertheless, the evidence is sufficient to suggest that there is more to this whole business than absurdity, naivete, or irrationality on the part of policy-makers. Most civil servants are neither stupid nor arbitrary and economists might well be somewhat less arrogant about the presumed superiority of "our" theory over "their" practice.

Within the framework of modern economic analysis, our theory leads us to the notion that “departures from unified exchange rates” are justifiable only in a few special circumstances or, more frequently, are a second-best solution to a problem. However, the “economically most efficient” solution to a problem is not always politically or administratively feasible. Going beyond the limits of economics as currently defined by the profession itself, solutions that Bhagwati (or most of the profession) call second-, third-, or even fourth-best, may be the only policies available other than acceptance of the status quo. The trend of recent years to define our subject matter more and more narrowly may very well lead to conditions in which we are formally correct — and quite scientific — but to a position where we can say rather little of practical value in the world of public affairs.