3.2.3 Smith's Qualifications of Laissez-Faire

Smith makes several specific qualifications of his laissez-faire policy recommendations.

First, he argues that defense or national-security considerations may require a nation to protect and subsidize a sector that otherwise would not be profitable. The example he gives is the British Navigation Laws of the eighteenth century, a complex system of restrictions on trade aimed at securing strong merchant shipping and ship-building sectors for Britain. Since Britain depended on its naval strength to defend itself against continental European powers, a pool of experienced seamen and ongoing ship-building facilities were an important national security asset. Smith endorses these navigation measures on this ground, despite his recognition that under laissez-faire Britain would not have a comparative advantage in shipping and ship-building, and that these sectors would become much smaller.

This general concern continues to arise in contemporary political economic debates. The U.S. has subsidized its merchant marine for many years, for example, and the U.S. government tries to intervene in computer and nuclear power markets on the basis of national security concerns.

Smith also endorses tariffs to even the tax burden on commodities when there is a tax on domestic producers. This is consistent with his goal of equalizing the real profit rate across sectors of investment.

A third qualification to pure laissez-faire is the use of tariffs as bargaining chips or retaliatory measures in international negotiations. Here the idea is that it might be worth paying a short-term economic price in national income in order to induce another country to adopt better policies. The U.S. uses this kind of economic policy quite frequently, for example, in our trade embargo on Cuba, trade restrictions with China, and linkage of trade privileges with other countries' domestic policies on human rights.

In line with his emphasis on increasing returns to scale through the increasing division of labor, Smith sees a role for tariffs in fostering the growth of small firms in important sectors, the *infant industry* exception to laissez-faire. The idea here is that the nation may have a *potential* comparative advantage in a sector if only it can reach a certain scale of production. Without protection, however, small firms venturing into the sector will be destroyed by existing foreign competition. A tariff in such a case may permit the growth of a large enough domestic industry to compete internationally. The contemporary Asian "tigers," including Korea, Taiwan, and Singapore have successfully encouraged infant

industries through tariff restrictions, export subsidies, and low-interest loans.

Finally, Smith acknowledges that there may be significant short-term adjustment costs to implementing laissez-faire policies, due to the slowness with which capital and labor disemployed in sectors vulnerable to foreign competition will be reabsorbed in other parts of the economy. To cope with these short-term adjustment costs, he accepts the need for a gradual movement toward laissez-faire through the elimination of tariffs and subsidies.

3.2.4 The State and the Market

While Smith has a lively and vivid appreciation of the spontaneous growth potential of the private economy through accumulation and the division of labor, he also puts forward a sophisticated and complex view of the relation between the market and the State. While he recommends against the State intervening in particular markets for purely economic ends, he sees a the need for the State to create the boundary conditions within which markets and enterprise can flourish. The State, for example, needs to guarantee property and enforce contracts in order to create the legal substructure within which trade and production can grow. But inevitably the definition of property rights and contract responsibilities involves the State in concrete issues of resource allocation and investment planning. The reason is that in defining the limits of property rights (through environmental regulations, zoning, regulation of monopoly, and the like) the State indirectly influences the directions in which the private division of labor will develop.

There are many modern instances of these political economic issues. We are in the midst of a major reform of property rights in the electromagnetic spectrum (radio and television broadcasting frequencies). Many countries, including the U.S., are moving to create transferrable property rights in parts of the spectrum, and as a result are creating new markets and new economic possibilities, as well as new sources of wealth. But these reforms also inevitably have a major impact on the development of the broadcasting, telephone, and information transmission industries. A similar development of property rights in various kind of environmental pollutants (sulfur emissions, greenhouse gas emissions) is in a more nascent stage on the international scene. The chronic debates and problems we have over health and automobile insurance are also closely related to the establishment of property rights and responsibilities.

Thus Smith's vision of laissez-faire is not a one-sided encouragement of private enterprise and the market to the neglect of political and gov-

ernmental institutions, but a balanced understanding of the interplay between market and State institutions in allowing the virtuous circle of economic development to proceed.

Discussion Questions:

What is Smith's conception of private self-interest? What might be some other conceptions? Does Smith's conception depend on the society he lived in?

What is Smith's conception of the general or public interest? How is this conception conditioned by Smith's society?

Is Smith's argument that the pursuit of self-interest serves the general interest a tautology (i.e., simply the consequence of his definitions of terms)? In what cases do you think it has real content?

What limits does Smith see to the workability of a laissez-faire policy? What assumptions does his support of such a policy depend on?

What are the relations between laissez-faire policy and the accumulation of capital? To what extent do the positive benefits of laissez-faire depend on capital accumulation?

How would you sum up Smith's view of a good society and a successful development of human character?

How does Smith use history in his thinking?

3.3 Smith's Theory of Money and Banking

Smith has characteristic views about money and banking, which have important ramifications in relation to later theories. He considers a *gold standard* system of money, in which the government has established a legal relationship between the national money (dollars or pounds or francs) and a quantity of gold. As we have seen, in this type of system the money prices of commodities are regulated over the long run by the relative production costs of gold and commodities. If the gold prices of commodities fall a lot, gold becomes more valuable in terms of commodities, gold production becomes more profitable, and resources will shift toward gold, which will tend to raise the gold prices of the other commodities. Similarly, if gold prices of commodities rise sharply, gold loses value in relation to other commodities, gold production becomes unprofitable, and the supply of new gold will decline. The price level (or inflation) in this type of system is influenced mainly by the gradual

change in relative production costs of gold and other commodities as technology changes.

The quantity of gold required to circulate the commodities in a country depends on the *velocity of money*, that is, how many transactions each gold coin can participate in over a year. The velocity of money can be measured as the ratio of the value of transactions in a year to the stock of gold money. On the average, the velocity of money in transactions depends on the payment customs of a country, and the degree of development of its banking system.

Smith puts considerable weight on the fact that the stock of gold required to circulate commodities is a drain on the profit-making capital of the country. If the country could increase the velocity of money, it could divert some of the capital tied up in holding gold into profit-making investments, and thus increase its wealth. One way the velocity of money can be increased is through the wider use of banks, which centralize the gold reserves of many depositors. Since the demands of different depositors for gold are not exactly correlated, the bank can hold a lower gold reserve than the depositors would need if each held their own, and the velocity of money increases. Smith, like many Scots, is an enthusiastic supporter of banking, banknotes, and *cash accounts*, an early form of credit card that allowed depositors to hold lower average balances in managing their affairs. (The English say that "the Scotch hate gold.")

Smith extends his laissez-faire recommendations to the banking system, proposing that banks should be allowed to issue as much deposits or banknotes as they wish, as long as they are in a position to redeem deposits and notes with gold on demand. In his view, banking and credit share the self-regulating character of the market in general. If banks issue more banknotes than the public wants to hold, the public will redeem the notes for gold, and thus regulate the total note issue to the appropriate size.

Smith was aware of certain pathologies that unregulated banking systems could support. These are all, in one way or another, connected with an unstable multiplication of credit. In Smith's time much trade was financed on *bills of exchange*, a receipt for goods in transit signed by the shipper, which other merchants and banks would accept as collateral for cash loans. In boom periods, some traders would issue bills beyond their actual inventories of goods in transit, which would allow an unstable growth of loans and credit in the economy as a whole. Such pyramids of credit are vulnerable to sudden crises, in which the failure of some of the issuers of bills to pay triggers off a chain reaction of other traders' failures. The credit system collapses temporarily, ruining many merchants, and often interrupting trade and production, creating

unemployment.

Smith argues that this kind of *overtrading* in bills of exchange can be avoided if banks strictly follow a policy of lending only on *real bills*, that is, bills of exchange that are backed by actual goods sold and in transit to their purchasers. This *real bills doctrine* has played a key role in banking policy debates ever since.

Smith's monetary theory is interesting in part because he is clearly not a *quantity theorist* of money in the modern sense. The *quantity of money theory of prices* argues that it is the quantity of money, rather than the cost of production of gold, that determines the average price of commodities. The quantity theory is the dominant consensus theory in modern policy circles, and underlies the *monetarist* policies of controlling money supply growth that many central banks have adopted. Smith argues for a flexible, demand-determined money supply, on the ground that, in a gold-standard system, the price level will be anchored by the production cost of gold relative to other commodities.

Smith's monetary views are also different from Keynes'. While Keynes argues that the quantity of money determines the interest rate (rather than the price level directly as the quantity theory predicts), Smith thinks the interest rate is largely determined by the rate of profit, not by the amount of money or credit created.

While both the Keynesian and quantity theories of money recommend interventionist monetary policies in which a central bank regulates the supply of money, either to influence interest rates, or to stabilize the price level, Smith's monetary theory fits consistently with a laissez-faire policy of banking.