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Evidence shows the 'internationalized' economy is nonsense

BY MILTON FRIEDMAN
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The popular message we hear repeated over and over is that somehow the world has really become internationalized. It is a new economy, a new world; we need new measures to cope with the widening industrialization of the world.

Ultimately, if you look at that message in greater detail, the main thing to be said about it is that it's a bunch of nonsense. The world is less internationalized in any immediate, relevant, pertinent sense today than it was in 1913 or in 1929.

Why is there this belief that there has been a great deal of internationalization?

Two things have produced it. One is the revolution in communications technology through satellites and computers, which has indeed internationalized the security markets of the world. They have become unified. It is possible at any time in a 24-hour period to buy securities – American securities, Canadian securities, British securities – in Hong Kong, or Singapore, or Japan, or New York, or London.

There has been no similar experience since 1867, when an even greater unification of world security markets occurred as a result of the completion of the transatlantic cable between London and the United States. Instead of waiting two weeks to find out what the price of the dollar was in London, you could get it in two minutes. That was a much greater improvement than satellites have brought.

Aside from the internationalization of the financial market, which is a reality, there has been a lot of talk about the internationalization of the market in goods and services. It is said that international trade has expanded so much, particularly in the United States, because U.S. imports and exports have gone up very rapidly in recent years. Of course, it is partly the emphasis on the so-called balance-of-trade deficit.

If you take the long view, the fact of the matter is that foreign trade has declined over a much longer period than it has recently risen.

One way of looking at this is to take U.S. exports plus imports divided by two to get the average amount of trade and, then, divided again by the national income. I have done this, plotting the ratio from 1869 to 1987, a period of well over a century. For the greater part of that period the ratio was declining. The pattern is that there was a bump upward in the early part, which is the First World War; a downward bump later in the Great Depression; but, until the 1970s, the basic trend was downward.

In the 1970s there was a sharp explosion. Why? For two reasons. One reason was the emergence of worldwide inflation, which led to a distortion in prices and exchange rates around the world. The second reason was the emergence of the oil cartel, which led to a substantial increase in the price and cost of oil. But this inflationary trend peaked in 1980. It is now coming down, and will continue to come down. That aspect of it has been a very temporary phenomenon attributable to two particular causes.

The problem, while temporary, is likely to do a great deal of harm. This is a subject that is of great interest to Canadians, with all the discussion about the mislabelled free-trade treaty between Canada and the United States. It is likely to do a great deal of harm because the great increase in the export/import ratio was accompanied by a U.S. balance-of-payments deficit which caused a lot of concern and which has been leading to a very strong protectionist movement. This, in turn, has led to passage of the U.S. Trade Act, which I think is one of the worst things we have seen in this area since Smoot-Hawley in 1930.

Let me go back to the main story. It is not the volume of the movement of goods and services that counts. What really matters is the terms on which they exchange. In a unified world, the same goods sell for the same price in different places except for the cost of transportation. Oranges sell for the same price in California and New York – except for the cost of transportation. I think the same thing is true in Canada. The same goods sell for the same price in British Columbia and Quebec, except for the cost of transportation. The way to see if you really have a unified, internationalized world is to compare the price of the same goods in different countries, apart from the cost of transportation, which has become a very small cost over time.

In a unified world, the exchange rate between the Canadian dollar and the U.S. dollar would be such that a Canadian dollar would buy the same basket of goods as the number of U.S. dollars you could get for a Canadian dollar would buy in the United States. Economists call that purchasing power parity exchange rate. We also have an actual market rate.

One way to see how unified the world is, is to see how close those two are together and how much they differ from one another. This can be done by comparing ratios of purchasing power parity with market exchange rates for different countries.

Anna Schwartz and I published a book in 1982 called *Monetary Trends in the United States and the United Kingdom*. In it, we calculated an estimate of the purchasing power parity exchange rate between Britain and the United States from 1870 onward. Then we took the actual exchange rate and divided the one by the other.

The striking feature of that picture is that, until 1929, the actual exchange rate never departed very widely from the purchasing power parity exchange rate. Indeed, it never departed by more than 10 per cent, plus or minus. That's not perfect but it is pretty good.

But look what happened after 1929. During the Great Depression it went one way; after the war it went the other. Since then it has been moving up and down and has departed 40 to 50 per cent. Why? Because, as we concluded in our book:

"The cliché is, it has become one world. In the economic world the realty is clearly the reverse. The law of one price was far closer to being satisfied before 1931 than after."

"The technological improvements which might have been expected to unify the world have been more than offset by governmental intervention which has fragmented the world into separate isolated markets. This figure demonstrates vividly how powerful and effective government intervention has been in rendering the law of one price far less applicable after 1931 than it was before.

Let me close with a quotation from my favourite economist, John Maynard Keynes.

He really is one of my favourite economists. I don't agree with the doctrines he expresses in *The General Theory*, but it is a great book and he was a great economist even if he was wrong. That's a true test of greatness – to be wrong in a way which stimulates other people and produces further advances in knowledge. I doubt there has ever been a major scientist who hasn't been wrong.

In a book written right after the First World War, *The Economic Consequences of the Peace*, which first established him as an international celebrity, he wrote:

"Before August, 1914, the inhabitant of Lon-

(*continued overleaf*)

don could secure forthwth, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could then proceed abroad to foreign quarters without knowledge of their religion, language, or customs, bearing coined wealth upon his person and would consider himself greatly aggrieved and much surprised at the least interference."

Before 1914, in regard to the most important single component of internationalization, namely the freedom of people to move, anybody from anywhere in the world could present himself at Ellis Island in New York Harbour for immigration to the United States without having to go through long procedures in advance or qualify for an immigration quota.

The closing of the borders of the United States to immigration after the First World War did more to fragment the world and disunite it than all the technological improvements in computers and satellites have done to unite it.

The article EM8902 reprinted overleaf and above is used in Figure 4.5 of the STAT 220 Course Materials and in Statistical Highlight #99.

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