The Journal Of
Peace, Prosperity & Freedom

Alex Robson

Individual Freedom, International Trade, and International Conflict: Cobden Was Right

"There is no invisible hand in foreign affairs."

- **Brink Lindsey**

"If the tailor goes to war against the baker, he must henceforth produce the bread for himself."

- **Ludwig Von Mises**

"The natural effect of commerce is to lead to peace."

- **Baron de Montesquieu**

Introduction

Free countries do not tend to engage in foreign wars, in both an overall sense and against other free countries.[1] And, if we accept—as Hayek asks us to in *The Constitution of*

1 For empirical evidence on this proposition, see Chan (1984).

Liberty—that a state of individual freedom exists when coercion of some by the arbitrary will of others is reduced by as much as possible,[2] then it is readily apparent that there is no long run trade-off between security and peace on the one hand, and individual freedom on the other. It is not possible for a state of individual freedom and a state of war to coexist.[3] Deliberate interventions such as wars of liberation, violent rebellions against tyrants, and the overthrow of despots can and have altered the underlying conditions which have prevented freedom from flourishing, but in many instances they have not; and in any case such interventions cannot guarantee that a condition of freedom will persist after the despot has fled or been killed. Many conflicts begun in the name of promoting freedom have ended up reducing or eliminating freedom by allowed the state to grow,[4] by destroying human life, and by obliterating the institutions and physical resources that are required for production, free exchange and wealth creation. To rely solely on the ability of seemingly benign states to conduct and succeed in military interventions overseas; to forever entrust our own elected and unelected officials and the officials of foreign allies with the task of imposing peace and securing the individual rights of foreign nationals; and to argue that "there is no invisible hand in foreign affairs" and instead hope that the machinery of government and various national and international bureaucracies will ensure that freedom advances throughout the world and across time—these all appear to be positions that are completely inimical to classical liberal ideas and a commitment to limited government. For classical liberal scholars, a more viable method for peacefully advancing freedom at home and abroad—one that does not rely on the success of violent foreign interventions by seemingly benevolent states—is preferable, if such an approach exists.

To begin to explore such an approach, it is instructive to investigate exactly why, at any given point in time, not all countries are engaged in armed conflict with one another. On the one hand, our own statesmen and diplomatic officials may be unelected warmongers; on the other hand, their foreign counterparts may be elected, benevolent pacifists possessed of no great diligence or skill in their negotiations with other diplomatic officials. This does not mean that war will break out instantaneously. International rules and customs may constrain the behavior of statesmen and diplomatic officials. More importantly, officials cannot completely ignore their own interests or the nature and composition of politically effective coalitions in their own countries.[5] In some countries there exist potentially large

2 Chapter 1, page 11 of *The Constitution of Liberty*.

3 Cobden, for example, states that "it is not by means of war that states are rendered fit for the enjoyment of constitutional freedom; on the contrary, whilst terror and bloodshed reign in the land, involving men's minds in the extremities of hopes and fears, there can be no process of thought, no education going on, by which alone can a people be prepared for the enjoyment of rational liberty." [Cobden, 1878, p 20]

4 See, for example, Higgs (1987). Peltzman (1980) takes the opposite view and argues that the evidence suggests that government does not need wars or crises to grow.

5 We will assume throughout this essay that the reader accepts the proposition that diplomats act in their own self-interest, where "self-interest" is broadly defined. It is widely accepted by economists that even terrorists act in their own interests and will behave according to the perceived costs and benefits of various actions available to them. In more familiar political systems (but not necessarily democracies), Stigler (1988) (at pages x-xi) argues convincingly that "political outcomes in the political "marketplace" for legislative goods and harms will depend on the nature and composition of the politically effective coalitions and the size and

agency costs between citizens and their representatives, so that domestic political concerns do not enter that strongly into an official's calculus of the costs and benefits of conflict. But it will nevertheless be the case that, from the official's own point of view, the higher the perceived costs of armed conflict, the less likely that official will advocate conflict with another nation.[6] At any point in time, the lack of accountability between citizens and their representatives will be determined by domestic political institutions, customs and constitutional rules, and these, like international rules and institutions, cannot be altered in the short run by international negotiations. An important determinant of the behavior of nations and their diplomatic representatives, then, will be the perceived costs and benefits of conflict, relative to peace. The key to developing a classical liberal approach to international affairs is to understand exactly how these costs and benefits are determined, and how they might be exploited over the long run to influence the behavior of government officials and diplomats.

I. International Organizations And International Rules: The Problems Of Incomplete Knowledge And Imperfect Enforcement

In *Law, Legislation and Liberty*, Hayek emphasized that modern human societies are *not* organizations: the order we observe is not a *made* order, or what Hayek also refers to as *taxis*.[7] Hayek's observations have important implications for international affairs. International institutions like the United Nations Security Council, the World Trade Organization, the International Monetary Fund and the World Bank *are* indeed organizations in the Hayekian sense. They follow certain procedures to create their own internal order, but at the same time they attempt to create a made order between the citizens of different nations by endeavoring to regulate national defense policies, international trade, international financial transactions and capital flows, and foreign aid.

These organizations have failed to prevent international conflict,[8] international financial collapses, and trade wars, and have not alleviated world poverty; in short, they have failed in their endeavors to create an international order. These facts should not surprise classical liberal scholars. As Von Mises states:

> 'It is futile to place confidence in treaties, conferences, and such bureaucratic outfits as the League of Nations and the United Nations. Plenipotentiaries, office clerks and

nature of the programs they achieve."

6 The recent diplomatic disputes in the UN Security Council on the Iraq issue between France, Russia and Germany on the hand, and the US and the UK on the other, are a perfect illustration of how rational actors pursue their own interests in international affairs according to a cost-benefit calculus, where such costs and benefits are broadly defined to include political wealth. The behavior of all parties in this episode strongly supports the empirical validity of the analytical approach of methodological individualism that underpins public choice analysis.

7 See Hayek, *Law Legislation and Liberty*, Volume I, p 37.

8 For example, the Cold War, the Korean War, the Vietnam War, and the two Gulf Wars have all occurred in the UN era.

> experts make a poor show in fighting ideologies. The spirit of conquest cannot be smothered by red tape'.[9]

Hayek and other Austrian economists emphasized that a made order—an international *taxis*—will only be possible if these international institutions possess complete knowledge of the end desires of the citizens of all nations, the means available to them, and all other relevant facts in all conceivable particular situations (including the actions available to all nations and the consequences of those actions).[10] From a purely bureaucratic standpoint, if international organizations had full knowledge of all of the consequences of the particular actions of all citizens in all countries, then individuals in those countries could simply find out which actions best serve their interests (or be directed by fiat), and then take those actions. Direct *commands* by international organizations in order to achieve some overarching international goal (such as "world peace") would then be feasible, although *international rules* may be no less desirable as a way of "creating" this order.

There are at least two major problems with international organizations that attempt to create an international *taxis*.[11] First, such bodies will never have perfect knowledge of the end desires of individuals or their representatives. This is particularly true in the modern international economy, where billions of international economic transactions and social interactions take place every day, and where national defense policies respond to, and are determined by, alliances and rivalries between nations, which in turn are determined by the perceived interests that are at stake and which change on a regular basis. The second problem is that of *enforcement*: who will enforce commands by an international body against the governments of belligerent nations? The establishment of a world government is not a viable solution, as it would not eliminate the problems associated with limited knowledge (and may in fact exacerbate them).

International order cannot be created by human design; instead, in the long run the order that we observe is a *grown* or *spontaneous* order—what Hayek referred to as *kosmos*. But how does international order grow? In pursuing their own ends, the citizens or governments of some come countries may carry out acts of aggression against the citizens or governments of other countries. *International rules of conduct* or general principles of behaviour between nations might be required to minimize such coercion. Such rules bring states together into an international order, but they cannot be structured separately from, and nor are they logically or factually antecedent to, international society. The rules and institutions that survive are mostly procedural. For example, the theory of a "just war", codified by St. Augustine and Thomas Aquinas, has ancient roots dating back to Cicero. In many cases these rules are not formally devised and enforced, but may simply take the

9 See Von Mises (1996), page 825.

10 We do not mean to argue here that these institutions are irrelevant or have no effect on international affairs; clearly, they do. But they do not, by themselves, create international order.

11 The arguments here apply equally well to individual national governments who might consider attempting to "create" international order.

form of traditions or conventions.[12] They may frequently be "irrational", in the sense that nobody can articulate them or explain why they exist. The reason that international rules work where commands fail in a world of incomplete knowledge is that in the vast majority of situations, what an individuals lacks in knowledge of particular factual situations he can make up for by building up knowledge of the *abstract*. Individuals can and do acquire knowledge of abstract, general, simple rules quite readily. Because human knowledge of the particular is limited, the distinction between general international rules, and not international commands—*international law*, as opposed to *international government*—is the key to understanding how international order grows.[13]

Such international rules and traditions can be regarded as long-term international contractual agreements to observe particular norms, limit the buildup of weapons, and so on. But in a world of incomplete knowledge, such a system of complete contingent contracts is not possible, and if contingencies arise that are not planned for, one or all of the parties to such implicit international agreements might have an incentive to breach contractual terms. Thus, while abstract rules attempt to deal with the lack of knowledge inherent in international affairs, they can potentially run into the same problem as commands; to wit, in a system of international rules we are still left with the same question: if they are breached, who enforces them?

The answer is that in the long run, such rules will only be observed by any given pair of nations if they continue to serve the mutual interests of those nations. In other words, if international rules of conduct are to minimize international conflict and allow individual freedom to flourish, they must be *self-enforcing*. The fundamental question, then, is how a system of stable, self-enforcing rules of international conduct—a self-enforcing international *kosmos* which maximizes individual freedom and minimizes international conflict—can emerge and endure over time.

II. Growing An International Order By Increasing The Opportunity Costs Of Conflict: The Positive Security Externality Of Free Trade

A. *The Classical Liberal Position: Cobden, Smith and Montesquieu*

A self-enforcing system of common rules between nations has a greater chance of surviving if, in the unforseen contingencies where countries can *ex post* act opportunistically, the costs of such actions are high, relative to the benefits. The unconditional right of nations to engage in self-defense in response to unprovoked aggression is an important example of a longstanding international convention which acts as a deterrent by increasing the expected costs of unprovoked, opportunistic aggression. Such a rule is only credible, however, if it is

12 This view of international law has a long tradition, dating back to the Dutch jurist and natural law scholar Hugo Grotius. See, for example, Beck et al (1996), Chapter 2.
13 Note that a perfect international order can never, in fact, be realized by any system. Man is not perfectible, and neither are his institutions.

if backed up by the development of weapons of self-defense by all nations. If such weapons can also be used for offensive purposes, then any equilibrium in international affairs will be inherently unstable. There is another, simpler measure that might increase the costs of aggression and conflict, and which can be taken *unilaterally* by countries: free trade (broadly defined). As Von Mises points out:

> 'There is perfect agreement…that total war is an offshoot of aggressive nationalism. But this is merely circular reasoning. We call aggressive nationalism that ideology which makes for modern total war. Aggressive nationalism is the necessary derivative of the policies of interventionism and national planning. While laissez faire eliminates the causes of international conflict, government interference with business and socialism creates conflicts for which no peaceful solution can be found. While under free trade and freedom of migration no individual is concerned about the territorial size of his country, under protective measures of economic nationalism nearly every citizen has a substantial interest in these territorial issues. … What has transformed the limited war between royal armies into total war, the clash between peoples, is not technicalities of military art, but the substitution of the welfare state for the laissez-faire state'.[14]

There are at least two ways in which the expansion of international trade—broadly defined—may reduce the possibility that conflict arises, and thereby allow freedom to flourish. First, exchange of cultures and ideas reduces the possibility of conflict by encouraging the development of rules, conventions and mutual understandings which can be used to manage *low-intensity conflict* between states, so that, even if low-intensity conflict arises (as it inevitably must), it will not escalate into total war.

Secondly, and more importantly, trade has a direct effect on the likelihood of conflict by increasing the net costs of conflict. It is widely recognized that international trade in goods and services, factors of production, and the free exchanges of ideas and cultures generates great material wealth.[15] By creating the promise of future riches, such exchanges create large mutual dependencies between the citizens of different countries, and these dependencies enter into the costs and benefits of conflict and peace in a straightforward way: the greater is the mutual dependence between citizens of different countries, the greater is the cost of armed conflict, since conflict is likely to temporarily or even permanently put an end to trade. If self interests, rather altruistic desires for world peace, drive international relations, and if mutual dependence influences these interests, then, *ceteris paribus*, it is such dependencies—not the individual skills, abilities of diplomats or their personal feelings about war and peace, or bureaucratic outfits and their "plenipotentiaries, office clerks and experts"—which will ultimately matter in international relations in the long run. If mutual dependencies between the individual citizens of different countries can somehow be strengthened, independently of the actions of government officials—if the

14 *Human Action*, p 823–824.
15 See section B below.

political and economic costs of armed conflict could be increased—then it is possible that conflict would be less likely to occur, and freedom more likely to flourish.

These ideas are not new. They can be found in the writings of Emeric Cruce, Francois Quesnay, David Hume, Adam Smith, Baron de Montesquieu, John Bright, and in Richard Cobden's speeches and pamphlets. For example, in 1850, Cobden declared:

> 'I believe the progress of freedom depends more upon the maintenance of peace and the spread of commerce and the diffusion of education than upon the labor of Cabinets or Foreign Offices. And if you can prevent those perturbations which have recently taken place abroad in consequence of your foreign policy, and if you will leave other nations in greater tranquillity, those ideas of freedom will continue to progress, and you need not trouble yourselves about them'.[16]

Cobden's advocacy of the policy of non-interventionism in international affairs did not mean that he was indifferent to the affairs of other countries, or that he advocated a policy of moral isolation,[17] since this was inconsistent with his pleas for greater international interdependence and increased material intercourse between countries. He simply believed, as Smith, Montesquieu and others did before him, that international trade, rather than discrete interventions in the internal affairs of other countries, was more likely to lead to international cooperation, peace and freedom over the long run. In doing so, Cobden attempted to bring the peace movement into the free-trade coalition. In other words, Cobden, Smith, Montesquieu and others argued that free trade produced a *positive security externality* which would promote peace and enhance the progress of individual freedom.[18] Friedman (1962) makes a related claim:

> 'Instead of making grants to foreign governments in the name of economic aid—and thereby promoting socialism—while at the same time imposing restrictions on

16 The quote is from a speech given by Cobden in the House of Commons on June 28, 1850. Cobden was responding to a motion of confidence regarding the foreign policy of Lord Palmerston (Henry John Temple), who was the foreign minister in the Whig government of Lord John Russell. Earlier, on June 15, Palmerston had directed 15 ships of the Royal Navy to enforce payment of several small claims by British subjects (worth a total of 33,000 pounds) against the Greek government. A Greek naval vessel was seized and a harbor was blockaded, but ultimately a compromise of 6,400 pounds on the outstanding debts was reached before Cobden gave his speech. Palmerston was eventually sacked by Russell in 1851 for congratulating Louis Napoleon Bonaparte on his coup in France, and for recognizing the government formed by Napoleon without consulting with his fellow cabinet ministers. For further details of the episode, see Hinde (1987), chapter 10.

17 Many scholars suggest that Cobden "never advanced the opinion that all wars not undertaken for self defence were always wrong or inexpedient", and contend that he merely argued against a policy of intervention in the internal dissensions of other countries. See, for example, Mallett (1878), pp xiii-xiv.

18 Although Cobden was heavily involved in the movement to abolish the Corn Laws [see, for example, Prentice (1968)], he did not take positions that could be described today as classically liberal on all topics. For example, on the role of government in education, he wrote that "I am convinced that government interference is as necessary for education as its non-interference is essential for trade. Any voluntary scheme is a chimera." [emphasis in original] (Letter to Coppock, 15 June 1847).

> the products they succeed in producing—and thereby hindering free enterprise—we could assume a consistent and principled stance. We could say to the world: We believe in freedom and we intend to practice it. No one can force you to be free. That is your business. But we can offer you full cooperation on equal terms to all. Our market is open to you. Sell here what you can and what you wish to. Use the proceeds to buy what you wish. In this way cooperation among individuals can be world wide yet free.'[19]

Cobden's proposition, then, depends on the size of the gains from free trade and the mutual dependencies that trade links create. If these are not large or are in fact negative, then we can immediately reject Cobden's hypothesis. On the other hand, if we conclude that there are large gains from free trade, then further examination of Cobden's hypothesis is warranted.

B. *The Gains from Free Trade*

Although the importance of the gains from trade are frequently highlighted by many classical liberal economists, the classical liberal case for free trade does not stand or fall on utilitarian arguments regarding the size of the welfare gains that are associated with shifting from a policy of autarky to free trade. The right of two individuals to exchange the fruits of their own labor at any price that is voluntarily agreed upon is a strong theme running through many natural rights and non-consequentialist approaches to individual freedom, and does not change if the voluntary exchange occurs across national borders. However, because the arguments of Cobden, Smith, Montesquieu and others regarding the positive security externalities of free trade *explicitly* rely on the size of the costs and benefits of conflict relative to peace, it is necessary to consider these gains in some detail.[20]

The standard microeconomic argument for opening up an economy to free trade from a position of autarky relies on differences between the prices of goods and services that arise in autarky on the one hand, and the existing prices that prevail on world markets on the other. If there are no price differences, then no gains from trade exist. Price differences can arise from either differences in consumer tastes or from differences in production conditions (factor endowments, technological capabilities, and so on). The latter give

19 *Capitalism and Freedom*, page 74.

20 We are assuming here that the reader understands the other fundamental roles that markets play in promoting economic freedom. First, markets solve the resource allocation problem: they shift finite resources away from individuals who place a low value on them, to individuals who place a higher value on them, in a voluntary, mutually beneficial fashion, without resources being needlessly wasted. While there is no guarantee that these market allocations will eliminate the jealousy and envy of certain individuals—also known among socialists as "social justice", "equity" or "fairness "- but in a complex world where billions of economic decisions are made every day, the ability of markets to solve the vast majority of resource allocation problems is unquestioned: there are no simply no other mechanisms known to humans that can perform this function at all, let alone as successfully as markets actually do. Secondly, prices in competitive markets act as signals to tell individual producers and consumers how they should act in the future, even though these individuals do not know (or care) why prices are changing. See Hayek (1945).

rise to the idea of comparative advantage: a country has a comparative advantage in the production of a good if the opportunity costs of producing a unit of that good are lower than the corresponding opportunity costs of producing a unit of that good in the rest of the world. In standard trade theory there are two sources of comparative advantage: technological differences, which were first analysed by David Ricardo; and differences in relative factor endowments, which were first analysed by Heckscher and Ohlin.

Although the sources of comparative advantage differ in these two approaches, the consequences of an economy opening up to free trade are the same, and are essentially due to a separation of consumption and production decisions that occurs under conditions of free trade.[21] In autarky, a country is constrained to consume exactly as much as it produces. If the country is opened up to free trade and world prices differ from autarky prices, there are two potential sources of gains. First, suppose that the country is still constrained to produce its autarky level of output. The country may now exchange this output on world markets at world prices, and is no longer constrained to consume what it produces. This *consumption gain* allows consumers to rearrange their consumption patterns in ways which were not possible under autarky, even if production is unaltered. Secondly, the ability to sell goods at different international prices allows produces to rearrange their production patterns in ways that were not possible under autarky, and to even specialize completely in the production of a single good. This *production gain* arises because producers are no longer constrained to sell all of their output on domestic markets, but can sell as much as they want to the rest of the world at prevailing world prices. Neither the production or consumption gains depend on whether world prices are higher or lower than domestic autarky prices—this simply determines which goods the country will export and import.[22]

There have, of course, been many empirical studies which estimate the welfare gains of removing various trade restrictions, but it is difficult to measure the gains from moving from *complete* autarky to *complete* free trade, since almost no modern country is completely autarkic or completely free of trade barriers. However, some studies of such episodes do exist. For example, in an important paper, Huber (1971) examines the move by Japan from a position of virtual autarky in 1858 to one of nearly free trade in the 1870s after the Meiji Restoration, and finds that the gains were dramatic—real national income rose by as much as 65 percent in 15 years, and the Japanese terms of trade improved by 340 per cent.

There are other static sources of gains from international trade that have been explored in the literature. For example, if industries are characterized by high fixed costs, then in autarky domestic producers may find only it profitable to produce one good, and consumers must consume that good alone. Under free trade consumers may now consume more than one kind of good, and if they have a 'love of variety' there will be a consumption gain from free trade, even though the prices of goods may not change after free trade occurs.[23]

21 Irving Fisher was the first to point out this separation.
22 The gains can also be illustrated diagrammatically. For example, see Bhagwati et al (1997), page 283.
23 See, for example, Krugman (1979) and Helpman (1981).

The idea of comparative advantage can also be extended to deal with *intertemporal* trade in a straightforward fashion. In this case, instead of countries having comparative advantage in the production of goods at a single point in time, countries have different attitudes towards intertemporal substitution in consumption and different factor endowments over time.[24] Again, in this context autarky simply means that a country's aggregate savings (postponed consumption) must equal its aggregate investment at any given point in time. But opening up to international trade again leads to two potential sources of welfare gains, as long as the autarky interest rate differs from the interest rate that prevails on world markets. At the prevailing world interest rate, both consumers and producers may now rearrange their consumption and production decisions over time and borrow or lend as much as they wish. Aggregate savings need no longer equal aggregate investment—the discrepancy in any one period is simply reflected as a current account deficit (if the country is a net borrower) and a current account surplus (if the country is a net lender).

Finally, the principle of comparative advantage may also apply to *trade across states of nature*, or risk sharing, which takes place on domestic and international equity markets.[25] If risk averse producers and consumers in different countries face different risks, have different attitudes towards risk, or have different assessments of the probabilities of various events, then there will typically be large potential welfare gains if there is a possibility of insuring against these risks on international markets. Again, the principle is the same: opening up to international trade removes the constraint that domestic demand for various risky assets must equal domestic supply.[26]

It is also interesting to note that the mobility of factors of production (for example, labor and capital) can act as a substitute for trade in goods and services.[27] In other words, even if a country does not engage in free trade in goods, if it allows factors of production to freely cross its borders, then the welfare gains are identical to those it could realize under free trade in goods and services. The explanation for this result is based on the equalization of factor prices that occurs when there is free trade in goods and services and identical technology in all countries. Under free trade, welfare gains exist as long as there are price differences across countries. The prices of goods change as trade is opened up, and as firms produce more of the goods in which they have comparative advantage, demand for factors of production change. When goods prices are equalized, as they are under perfectly free trade, then the prices of factors must also be equal. Thus, an alternative way of capturing the gains from free trade is to allow factors to flow freely across borders, until factor prices are equalized. Since, under such conditions, factor prices are equal, it must also be the case that goods prices are also equal, in which case all gains from trade in goods and

24 See, for example, MacDougall (1960). For a textbook treatment, see Obstfeld and Rogoff (1996).
25 See, for example, Svensson (1988) and Obstfeld (1994). Again, for a textbook treatment, see Obstfeld and Rogoff (1996).
26 The application of the gains from trade to intertemporal trade and international risk sharing is a simple consequence of the idea, first pioneered by Debreu (1959), that goods are distinguished by their date of availability, location, and the state of nature in which they are available.
27 See, for example, Mundell (1957) and, more recently, Wong (1986).

services have been exhausted. In this sense, as far as the gains from international trade are concerned, we can define international trade in quite a broad fashion, at least for the purposes of analyzing the security externalities of trade. In other words, it does not matter whether we are thinking about trade in goods and services, factors of production, or exchanges of culture and ideas; in all cases, we should expect to find large gains from international trade.

C. *Trade, Security and Conflict: The Security Externalities of International Trade*

1. Early Research: The Model of Polachek

Economists have explored the gains from international trade in great detail ever since the issue was raised by David Ricardo and Adam Smith, but up until very recently there has been very little attention paid to the relationship between trade on the one hand, and international security and conflict on the other. The gains from trade may indeed be large, but how exactly does this inhibit conflict?

In a series of important papers, Polachek[28] has formalized the idea, long believed by classical liberal scholars in economics and political science, that opening up to international trade can reduce the possibility of conflict between nations. The essence of Polachek's argument is straightforward. Countries produce a given level consumption goods and consume a given amount of "hostility", a term which is meant to encompass weapons production, the severity and frequency of threats against other countries, and so on. Both consumption goods and hostility enter into the utility function of the nation in a positive fashion. The relationship between world prices and autarky prices determines which goods the country will import and export. If a country is behaving optimally, it will choose consumption goods and hostility in such a way that the marginal costs of hostility are equal to its marginal benefits.

In Polachek's model, the marginal costs of hostility depend negatively on changes in the costs of the country's imports and positively on changes in the value of the country's exports. An unfavorable change in the terms of trade faced by a country (an increase in the price of imports), reduces the marginal cost of hostility, and so is likely to increase the amount of hostility that a country engages in. Similarly, an increase in the world price of a country's exports increases the marginal cost of conflict, and is likely to lead to a reduction in consumption of hostility. In autarky, the price of the country's exported goods are as low as possible, and the price of the country's imported goods are as high as possible. Hence, autarky leads to the maximum amount of hostility, and a country will enjoy a positive security externality if it opens its markets to the rest of the world. The larger the gains from trade, the greater the positive security externality. Quantity restrictions on international trade in the form of quotas or price distortions in the form of tariffs also result in countries engaging in more hostility than it would in a free trade environment, where such distortions are absent.

28 See Polachek (1978, 1980, 1992, 1997); Polachek and Gasiorowski (1982); and Polachek et al (1999).

2. Recent Research

The main criticism of Polachek's work is that it does not take into account the fact that hostility is an inherently *strategic* variable. In an important recent paper, Skaperdas and Syropoulos (2001) [SS] examine the security externality of trade in more detail, using the modern tools of non-cooperative game theory. They consider a two country, two good general-equilibrium trade model, in which there are insecure international property rights over one of the commodities. Countries can invest in weapons in order to capture a fraction of this commodity, which can either be consumed or traded on world markets at a fixed world relative price. They model conflict as a *probabilistic* contest, using a rent-seeking approach which is widely used by public choice scholars, and which was originally developed by Tullock (1980) and axiomatized by Skaperdas (1996).[29]

Skaperdas and Syropoulos find that a country's incentives to arm depend on the price of the insecure commodity on world markets, relative to the price that obtains in autarky. If the world price of the insecure commodity is above the autarky price, then opening up to trade makes the insecure commodity more valuable, and encourages each country to invest in arms, increasing the intensity of conflict and reducing welfare in both countries. Thus, autarky may be preferred to free trade, both because welfare is lower and there is a greater intensity of conflict. The security externality of trade is negative in this case. However, if the world relative price of the insecure commodity is sufficiently low, then opening up to trade with the rest of the world creates a disincentive to invest in arms, since the marginal benefit of arming is lower, the less valuable is the insecure commodity on world markets. In this case, the security externality from free trade is positive. This conclusion is similar to the conclusion of Polachek, in the sense that exogeneous changes in world prices can influence the incentives to engage in armed conflict. The main difference in two approaches, however, is that in the SS model, autarky may in fact reduce the intensity of conflict. This proposition is testable.

D. *Anti-Liberal Arguments*

It is instructive to briefly examine the arguments of modern political scientists who take an opposite stance on the relationship between trade and conflict to that of classical liberals. While nearly all of these arguments are based on false claims regarding the benefits of free trade which were rejected by economists long ago, some economists refute Cobden's hypothesis for other reasons. For example, in relation to the recent US intervention in Iraq, economist Brink Lindsey writes:

> 'What is the basis for assuming that interventionism always makes matters worse? In economic policy, there are extremely solid grounds for opposing intervention in markets. In economics, market competition has enormous advantages over

29 Hirshleifer (2001) uses this approach to analyze a variety of similar question in economics and political science. Other recent work on this topic includes Anderson and Marcouiller (1997) and Anderton et al (1999).

> government action in making use of and coordinating dispersed information, in encouraging innovation, in supplying appropriate incentive structures, etc. Accordingly, anyone arguing that intervention in the marketplace can improve economic performance has an extremely difficult case to make. But . . . there's no invisible hand in foreign affairs. There are no equilibrating mechanisms or feedback loops in the Hobbesian chaos of state-to-state relations that give us any assurance that, if the United States were only to stand aside, things would go as well for us in the world as they possibly could'.[30]

Some political scientists refuse to even concede Lindsey's first point regarding intervention in markets. For example, one school of thought regards mutually consensual exchange as a negative sum game. Although these scholars agree that the outbreak of armed conflict between nations is likely to reduce trade, they claim that the market for international goods and services is essentially like a fixed pool of resources, for which countries compete in a perpetual hostile struggle of all against all.[31] As a greater number of countries trade with one another, more global resources are dissipated, and the more likely is conflict between nations. In this approach, colonialism and imperialism are the natural result of globalisation.[32] International trade is essentially a large negative sum prisoner's dilemma with many players. Countries are stuck in a Pareto inferior equilibrium of free trade, which they would like to escape from—if only they could coordinate their actions on the mutually preferable situation of global autarky!

A second school of thought in international relations is based purely on a belief in the benevolence of nationalistic governments towards their own citizens. Scholars in this school agree that globalization restricts the ability of states to act against the interests of their citizens, but they take exactly the opposite position to classical liberals, arguing that this is likely to lead to conflict between states, since states feel "weak and vulnerable" and "threatened" by other states when globalization occurs and restricts their options.[33]

Some political science scholars reject the classical liberal position for the reason that trade is driven by envy rather than absolute individual gains.[34] They argue that although freeing up international trade results in absolute welfare gains for a country, it is *relative* gains that are really more relevant for the behavior of states. In other words, if nations differ in the gains that they receive from freeing up international trade, simple jealousy can drive those nations to engage in hostilities with one another. In this approach, free trade is a kind of "rat-race" which will always lead to international conflict unless some kind of centralized global redistribution mechanism is established to deal with the "global inequalities" that

30 See Lindsey (2002). We are not making any claims about the wisdom of the recent US intervention in Iraq; we are simply arguing that Lindsey's assertion that "there is no invisible hand in foreign affairs" is incorrect.
31 See, for example, Hobson (1902).
32 The foundations of this approach can be traced to the writings of Lenin, who in the title of his 1916 book claimed that "imperialism is the highest stage of capitalism."
33 See Waltz (1970).
34 See, for example, Gowa (1994).

"inevitably" result from free trade.

Finally, some political scientists and economists argue that foreign aid is superior to free trade as a way of raising living standards in poor countries and reducing hostility. This contention—based on an attachment to international wealth redistribution—is essentially a variety of global socialism, the success of which is simply contradicted by the evidence. As Friedman (1958), Bauer (1971) and Lal (1997) point out, no country ever grew rich from foreign aid. Other economists have recently destroyed many other popular myths regarding foreign aid. For example, Alesina and Dollar (1998) find that foreign aid flows are determined more by national defense and strategic concerns than by genuine need and poverty, and Alesina and Weder (1999) find that corrupt governments tend to receive more foreign aid.

E. *Was Cobden Right? Empirical Studies of the Trade-Conflict Nexus*

While it might be easy for economists to dismiss the approaches of anti-liberal political scientists to the trade-conflict question, it is not so easy to ignore the recent challenge by Skaperdas and Syropoulos to Polachek's original prediction. The matter must ultimately be settled by examining the empirical evidence. Had Cobden been alive in the 50 years of "Pax Britannica" and the great prosperity that followed his 1850 speech, his belief that free trade would lead to peace and freedom would perhaps have been reinforced. But he would also have been discouraged by the onset of the First World War and the return of mercantilism in the interwar years. These and other episodes of war and peace, mercantilism and free trade provide us with data and enable us to test Cobden's proposition. Fortunately, there is a wealth of econometric studies on the issue. The majority of these studies support Cobden's hypothesis.[35]

The studies typically proceed by using conflictual "events" of varying degrees of severity between pairs of countries as the independent variable, with controls including formal alliance formation, degree of democracy, political change, economic interdependence (measured by trade flows relative to GDP), geographical contiguity, population, military capabilities, economic growth, and other variables. Because the direction of causation may run from more conflict to less trade, the studies also correct for the potential simultaneity biases that may exist in the data. In Polachek's original 1980 article, he tests a ten-year, thirty country cross section, and finds that countries with the greatest levels of economic trade engage in the least amounts of hostility. He also finds that on average, a doubling of trade leads to 20 percent diminution of hostility between countries.

In later work, Polachek (1992) finds similar results for the period 1948–1978 for over 105 countries, while Polachek et al (1999) finds similar results for the 1958–1967 period for 30 countries. . Polachek (1997), using the same data set as Polachek (1992), examines the question of why democracies rarely fight each other, and finds that the fundamental factor

35 The empirical literature is surveyed by Reuveny (1999/2000), McMillan (1997), Morrow (1999) and Barbieri and Schneider (1999).

causing bilateral cooperation is trade, rather than democracy *per se*. The interpretation is that, because liberal democracies tend to trade more than non-democracies, they will engage in less conflict with one another because of trade links, rather than because of similarities in political systems.

Other researchers have found similar results. Oneal et al (1996) analyze episodes of conflict over the 1950–1985 period, controlling for alliances, geographic contiguity, and relative power. They find that trade has a powerful influence on peace, particularly among contiguous states, which are, on average, more war prone. Oneal and Russett (1997, 1999) obtain similar results, using a wide variety of specifications.

Still more studies give indirect support to Cobden's hypothesis . Pollins (1989) tests a model of bilateral trade flows for a cross section of countries over the 1960–1975 period. He finds that trade flows are significantly affected by broad political relations of amity and enmity between nations. Richardson and Kegley (1980) analyze foreign policy relations between the United States and 25 of its trading partners between 1950 and 1973, and find that greater dependence leads to compliance with US foreign policy preferences.

Examples of findings in the opposite direction include Barbieri (1996). Gasiorowski (1986) and Barbieri and Levy (1999) find evidence that both supports and refutes the Cobden hypothesis. But McMillan (1997), in her summary of this body of work, analyzes the findings of twenty empirical studies. Overall, she finds that the majority support the hypothesis that interdependence inhibits violent conflict. On the whole, then, most studies support Cobden's hypothesis.

III. Concluding Remarks

The proposition that international trade in goods and services, factors of production, ideas and cultures increases mutual dependencies, lowers the possibility of international conflict by making it more costly, and allows individual freedom to flourish can be found in the writings of Emeric Cruce, Francois Quesnay, David Hume, Adam Smith, de Montesquieu, John Bright and, more recently, Ludwig von Mises. Richard Cobden, was also a powerful advocate of this idea. Although trade and economic interdependence can contribute to the peaceful resolution of disputes, they are not, by themselves, sufficient to guarantee the absence of war and the reduction of arming, and so they are not sufficient to guarantee the spread of international freedom. But, all else being equal, the gains from international trade—long emphasized by microeconomists as desirable in their own right—are a powerful deterrent against international conflict. And since freedom cannot exist under conditions of conflict or total war, international trade has an important indirect effect on the spread of individual freedom, both within countries and throughout the world.

This paper applied the insights of Austrian economists such as Hayek and von Mises to international affairs and international rules of conduct, and found that Cobden's intuitive arguments regarding foreign affairs and the progress of individual freedom are accurate,

at least in principle. We then briefly examined the most recent theoretical and empirical work by economists and political scientists on the link between international trade and conflict. The majority of studies support Cobden's position: there *is*, in fact, an invisible hand in foreign affairs, and it is the very same invisible hand of self-interested, mutually consensual exchange, which Adam Smith first brought to our attention in the *The Wealth of Nations*.

References

Alesina, A. and Dollar, D. (1998) "Who Gives Foreign Aid to Whom and Why?" NBER Working Paper Number w6612, NBER, Cambridge, MA.

Alesina, A. and Weder, B. (1999) "Do Corrupt Governments Receive Less Foreign Aid?" NBER Working Paper Number w7108, NBER, Cambridge, MA.

Anderson, J. and Marcouiller, D. (1997) "Trade and Security I: Anarchy." Unpublished manuscript, Boston College, October.

Anderton, C., Anderton, R. and Carter, J. (1999). "Economic Activity in the Shadow of Conflict," Economic Inquiry, January, 37(1), pp. 166–79.

Barbieri, K. (1996) "Economic Interdependence: A Path to Peace or a Source of Interstate Conflict?" Journal of Peace Research, 33(1): 29–49.

Bauer, P. (1971) Dissent on Development, London: Weidenfeld and Nicolson.

Beck, R. et al (eds) (1996) International Rules: Approaches from International Law and International Relations, Oxford: Oxford University Press.

Bhagwati, J. et al (1998) Lectures on International Trade, Second Edition, Cambridge: MIT Press.

Bright, J. and Rogers, J. (eds) (1878) Speeches on Questions of Public Policy by Richard Cobden, M.P., London: Macmillan and Co.

Chan, S. (1984) "Mirror, Mirror on the Wall…Are Freer Countries More Pacific?" Journal of Conflict Resolution, 28: 617–648.

Cobden, R. (1878) The Political Writings of Richard Cobden, London: William Ridgway.

Debreu, G. (1959) Theory of Value, New York: Wiley.

Friedman, M. (1958) "Foreign Economic Aid," Yale Review, 47: 500–516.

Friedman, M. (1962) Capitalism and Freedom, Chicago: University of Chicago Press.

Gasiorowski, M. (1986) "Economic Interdependence and International Conflict: Some Cross-National Evidence" International Studies Quarterly, 30(1): 23–38.

Gowa, Joanne (1994). Allies, Adversaries, and International Trade. Princeton, NJ: Princeton University Press.

Hayek, F. (1945) "The Use of Knowledge in Society" American Economic Review, 35, No. 4; September, 519–30.

Hayek, F. (1994a) The Constitution of Liberty, Chicago: University of Chicago Press.

Hayek, F. (1994b) Law Legislation and Liberty, 3 Volumes, Chicago: University of Chicago Press.

Helpman, E. (1981) "International Trade in the Presence of Product Differentiation, Economies of Scale and Monopolistic Competition: A Chamberlinian, Heckscher-Ohlin Approach" Journal of International Economics, 11: 304–340.

Higgs, R. (1987) Crisis and Leviathan: Critical Episodes in the Growth of American Government, New York: Oxford University Press.

Hinde, W. (1987) Richard Cobden: A Victorian Outsider, New Haven: Yale University Press.

Hirst, F. (ed) (1903) Free Trade and Other Fundamental Doctrines of the Manchester School, New York: Augustus M. Kelley Publishers.

Hirshleifer, Jack (2001) The Dark Side of the Force, Cambridge: Cambridge University Press.

Hobson, J. (1902) Imperialism: A Study, Ann Arbor: University of Michigan Press.

Huber, J. (1971) "The Effect on Prices of Japan's Entry Into World Commerce after 1858" Journal of Political Economy, 79: 614–628.

Krugman, P. (1979) "Increasing Returns, Monopolistic Competition and the Gains from Trade" Journal of International Economics, 9: 469–479.

Lal, D. (1997) The Poverty of Development Economics, Second Edition, London: Institute for Economic Affairs.

Lindsey, B. (2002) "There's No Invisible Hand in Foreign Affairs," published on the World Wide Web at http://www.brinklindsey.com/archives/001449.php

MacDougall, G. (1960) "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach" Economic Record, 36 (Special Issue): 13–35.

McMillan, S. (1997) "Interdependence and Conflict" Mershon International Studies Review, 41(1): 33–58.

Mallet, L. (1878) "Introduction" in Cobden, R. The Political Writings of Richard Cobden, London: William Ridgway.

de Montesquieu (1748) The Spirit of the Laws, 1989 Cambridge University Press edition, edited and translated by Cohler, A., Miller, B. and Stone, H.

Mundell, R. (1957) "International Trade and Factor Mobility" American Economic Review, 67: 321–335.

Obstfeld, M. (1994) "Risk-Taking, Global Diversification, and Growth" American Economic Review, 84(5): 1310–1329.

Obstfeld, M. and Rogoff, K. (1996) Foundations of International Macroeconomics, Cambridge, MA: MIT Press.

Oneal, J. et al (1996) "The Liberal Peace: Interdependence, Democracy and International Conflict: 1950–1985" Journal of Peace Research, 33(1): 11–28.

Peltzman, S. (1980) "The Growth of Government," Journal of Law and Economics, 23: 209–87.

Polachek, S. (1978) "Dyadic Dispute: An Economic Perspective," Papers of the Peace Science Society, 28: 67–80.

Polachek, S. (1980) "Conflict and Trade" Journal of Conflict Resolution, 24(1): 55–78.

Polachek, S. (1992) "Conflict and Trade: An Economic Approach to Political International Interactions", in Isard, W. & Anderton. C. (eds), Economics of Arms Reduction and the Peace Process, New York: Elsevier Science, pp 89–120.

Polachek, S (1997) "Why Democracies Cooperate More and Fight Less: The Relationship Between International Trade and Cooperation" Review of International Economics, 5: 295–309.

Polachek, S., Chang, Y. and Robst, J. (1999) "Liberalism and Interdependence: Extending the Trade-Conflict Model", Journal of Peace Research, 36(4): 405–422.

Polachek, S. and Gasiorowski, M. (1982) "Conflict and Interdependence: East-West Trade and Linkages in the Era of Détente," Journal of Conflict Resolution, 26(4): 709–729.

Pollins, B. (1989a) "Conflict, Cooperation, and Commerce: The Effect of International Political Interactions on Bilateral Trade Flows" American Journal of Political Science, 33(3): 737–761.

Prentice, A. (1968) History of the Anti-Corn League, Volumes 1 and 2, London: Frank Cass and Company.

Reuveny, R. (1999/2000) "The Trade and Conflict Debate: A Survey of Theory, Evidence and Future Research," Peace Economics, Peace Science and Public Policy, 6(1): 23–49.

Richardson, N. and Kegley, C. (1980) "Trade Dependence and Foreign Policy Compliance: A Longitudinal Analysis" International Studies Quarterly, 24(2): 191–222.

Skaperdas, S. (1996) "Contest Success Functions", Economic Theory, 7: 283–290.

Skaperdas, S. and Syropolous, C. (2001) "Guns, Butter, and Openness: On the Relationship Between Security and Trade" American Economic Review, May, 91(2): 353–357.

Stigler, G. (1988) "Introduction" in Stigler, G. (ed) Chicago Studies in Political Economy, Chicago: University of Chicago Press.

Svensson, L. (1988) "Trade in Risky Assets," American Economic Review, 78(3): 375–394.

Tullock, G. (1980) "Efficient Rent Seeking," in Buchanan, J., Tollison, R. and Tullock, G. (eds) Toward a Theory of the Rent Seeking Society, College Station: Texas A & M Press.

Von Mises, L. (1996) Human Action: A Treatise on Economics, Fourth Revised Edition, San Francisco: Fox and Wilkes.

Waltz, K. (1970) "The Myth of Interdependence," in Kindleberger, C. (ed) The International Cooperation, Cambridge, MA: MIT Press.

Wong, K. (1986) "Are International Trade and Factor Mobility Substitutes?" Journal of International Economics, 21(1/2): 25–44.