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What Adam Smith Knew About Trade Wars

The ‘father of economics’ was committed to free markets but believed there was a role for governments in the global economy

The Adam Smith monument in Edinburgh was unveiled in 2008.

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In recent weeks, the U.S. and China have announced tens of billions of dollars of import tariffs on goods including steel and aluminum, washing machines and bicycles, coal and diesel. With at least $200 billion of further tariffs in prospect on the U.S. side alone, the possibility of the world's first trillion-dollar trade war cannot be ruled out.

In response, many advocates of free trade have cited the great 18th-century political economist Adam Smith. In the words of The Economist, "Donald Trump is in a standoff with Adam Smith." On this view, the White House is overthrowing the principles laid down by the author of "The Wealth of Nations," a staunch foe of state intervention in the economy who argued not merely for the economic benefits of free trade but for its capacity to bring citizens of all countries together.

In fact, however, Smith's views on trade were more subtle and wide-ranging than this caricature would suggest. That doesn't mean he was a protectionist—far from it. But we do have to dig deeper into his ideas to understand what he was really saying about trade and why it matters.

Adam Smith is by general consent the most influential economist who ever lived—the "father of economics." His ideas have shaped many fields over the last 200 years, including not only economics but philosophy, political theory and social psychology. Smith is justly celebrated today for his insights into the nature of markets and for his famous analysis of how specialization—created by the "division of labor" and driven by the basic human instinct to "truck, barter and exchange"—creates economic value. The result is a kind of miracle: a massive, coordinated economy with no central planner or directing organization, created by people freely buying and selling in markets.

But Smith's view of markets is very different from the one found in standard economics textbooks today. He thought of markets not as abstract mathematical constructions but as dynamic and evolving institutions, shaped in different ways by tradition, norms, circumstances, law and government. It is this insight that connects "The Wealth of Nations" (1776) with Smith's first book, "The Theory of Moral Sentiments" (1759), a pioneering investigation of social psychology and the origins of moral values. For Smith,

markets exist not by divine right but because they have been shaped by human beings in ways that generate both private and public value.

What matters for Smith isn't the rhetoric of "free markets" but the reality of effective competition. It is competition that creates economic value and keeps markets honest. But Smith believed that government intervention doesn't always undermine effective competition. On the contrary: Government can create red tape, but it can also bust trusts and level playing fields. Unfortunately, people today tend to hear only the first half of this message.

In the 18th century, markets were typically beset by thickets of guild, church and state regulation, jealously enforced by insiders with privileged access to government. Smith's "system of natural liberty" was thus a profound and radical idea. Little wonder that he described "The Wealth of Nations" as "the very violent attack I had made upon the whole commercial system of Great Britain." At that time, any liberalization of the market was likely to increase both prosperity and equality.

Yet to describe Smith as a laissez-faire economist is a serious mistake. On the contrary, he offers support in "The Wealth of Nations" for a wide range of state interventions, ranging from a land value tax to regulation of the banks and currency. Particularly notable is Smith's vigorous critique of crony capitalism, focusing on three things we see everywhere today: "rent-extraction," or companies getting above-market returns, often through political connections; asymmetries of information and power, which allow market insiders to rip off outsiders; and "principal-agent" problems, whereby managers tend to act in their own interests at the expense of shareholders. Ultimately, he believes, it falls to government, as the basic guarantor of the legitimacy and fairness of the market system, to remedy these ills.

These insights carry over from domestic markets to the international arena. Smith argued vigorously for the long-term benefits of free trade, abroad as at home, and he generally opposed monopolies and colonial exploitation. But he was also a student of history and a supreme realist about power. Far from holding that free trade would create international

harmony, he believed that states would always seek to dominate each other, and argued for the importance of international law to maintain a stable trading order.

Smith also recognized that sometimes tariffs and other temporary retaliations might be called for—even though their continued use would tend to raise domestic prices, reduce competition and increase crony capitalism. Indeed, Smith supported the long series of laws known as Navigation Acts, through which Britain used its naval power to exercise strict control over its colonial and other trade. As he put it simply, “defense is of much more importance than opulence.”

Adam Smith, then, was no market fundamentalist. On trade as on many subjects, he resists the easy caricatures of the political right and left. And he remains supremely relevant to present-day concerns, from falling U.S. domestic competition to the monopolistic tendencies of the technology platforms, from smarter economics to better bank regulation. On these matters, as on tariffs and trade, we urgently need to rediscover his wisdom.

—This essay is adapted from Mr. Norman’s new book, “Adam Smith: Father of Economics,” which will be published by Basic Books on Sept. 11. He is a member of the British Parliament for the Conservative Party.