

**IN SEARCH OF THE LOST DISSENSUS:  
WAS POP LIBERALISM RIGHT? <sup>1</sup>**

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**1. INTRODUCTION**

In a 1993 paper, Paul Krugman argued forcefully that it was more important than ever before that undergraduate students get right the basic principles of international trade. The reason, he pointed out, was that, at the time, Americans were obsessed with the *problem* of “international competition”. A series of authors had argued that the fate of the American economy depended very much on how the country performed in international trade. Krugman, in response, argued that this view was nonsense and labeled it “pop internationalism.”<sup>2</sup> The essence of the “pop internationalist” fallacy for him lies in the belief that a national economy resembles a corporation. In his article, Krugman argued that the principles of what undergrads should know are summarized in the insights of Hume (the price-specie-flow-mechanism) and Ricardo (principle of comparative advantage). The key implication is that trade deficits are self-correcting. These are according to Krugman, not without some reason, the consensus views on trade and finance among the economics profession and the educated layman.<sup>3</sup>

With this in mind, Krugman listed six misconceptions about trade (listed below), which, in his view, should be dispelled. A correct understanding of the basic conclusions of neoclassical trade theory represents the ‘ABC’ of mainstream economics. These conclusions, namely that comparative advantage rules trade, and that trade-deficits are self-correcting, are presented as the *sine qua non* condition to respond intelligently to

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<sup>1</sup> We are thankful to Douglas Brooks and Jean Pierre Verbiest for their comments and suggestions.

<sup>2</sup> The main targets of Krugman’s critique were Laura Tyson and Robert Reich, then the head of the Council of Economic Advisors and the Labor Secretary in the Clinton administration.

<sup>3</sup> John Williamson (1990) included trade liberalization – a move towards free trade – as one of his ten items of the so-called Washington Consensus that dominated economic policies in the developing world during the last decade. Capital account liberalization – that is free movement of capital flows – was not part of the original agenda, but was an integral part of the International Monetary Fund (IMF) programs. We term this general consensus regarding the advantages of liberalizing both accounts of the balance of payments as pop liberalism, to contrast it with Krugman’s pop internationalism.

popular discussions of economic issues, in the sense that if one does not know them or, what is more important, one do not agree with them, one is regarded as obtuse.

The theory of comparative advantage is usually presented in two different forms. First as a normative proposition about what should happen in free trade. And second as a positive statement about the actual tendencies of free trade among nations. The latter claims that free trade will automatically make all nations equally competitive in the world arena, *no matter how different their existing levels of development* (Shaikh 1996). The theory admits that such differences may initially produce trade patterns in which the strong dominate the weak. But it argues that if market forces are allowed to prevail they will drive the real exchange rate to that level which will make trade balance among all countries. However, no such tendencies are discernible in the real life. In the words of Cohen: "History has shown itself to be cruel in this respect. The idea that trade is a factor of self-fulfillment in all places and at all times is theoretically naïve and historically false" (Cohen 1998, p.34).<sup>4</sup>

We believe that an in-depth discussion of Krugman's paper and underlying thesis is as relevant today as it was 10 years ago. Many countries in Asia are today obsessed with *the competitiveness question*, in particular with the People's Republic of China (PRC) in the picture, and economists often appeal to the theory of comparative advantage in search for arguments. After the financial crisis of 1997-98, it has proved to be a daunting task for countries in the region to get back to the outstanding growth rates that they achieved in the previous decades. And high growth is the key to development. At the same time, the PRC continues registering growth rates of 8-10 percent a year, with the consequence that there is concern in East and Southeast Asia about the "Chinese competitive threat." Burgeoning exports with cheap, productive labor, a seemingly unstoppable ability to capture new markets and, recently the accession to WTO, have led some to very pessimistic predictions.<sup>5</sup>

With this background, this paper has three purposes, which correspond to the main three sections in which it is divided. First, the paper discusses in section 2 the six

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<sup>4</sup> After the end of the Uruguay Round in 1993, it was claimed that poor countries would benefit most from the push toward global free trade. It is not all too clear that developing countries have been the great beneficiaries of the Uruguay Round. In a recent paper Hertel and Martin conclude that: "developing country exports of manufactures face much higher trade barriers than exports from developed countries. Their exports to high-income countries face average tariffs of 3.8 percent, a barrier four times as high as those facing developed country exports to these markets. The barriers that developing countries face in other developing countries are even higher at an average of 12.8 percent. Developing countries exports were found to suffer disproportionately from tariffs. Over 40 percent of total tariffs (42 percent for manufactures) were imposed on developing country exports in 1995 –as against a GDP share of 22 percent " (Hertel and Martin 1999, p.14). Beyond that, during the last round of trade talks that started in Doha in 2001 developed countries brought to the negotiating table issues related to investment, competition, property rights, transparency in government procurement and trade facilitation, sometimes referred to as the "Singapore issues." If developed countries have their way regarding these issues, it would be almost impossible for developing countries to pursue the sort of industrial policies that made industrialization in the developed world possible.

<sup>5</sup> In the US the competitive threat from developing countries is still an important preoccupation, at least in progressive circles. Bob Pollin (2003) refers to the competition from low wage countries as the Marx problem, that together with the Keynes (lack of demand) and Polanyi (race to the bottom in social standards) problems constitute the great challenges for policy makers in a globalized world.

misconceptions that Krugman pointed out. The section unravels some fallacies in Krugman's argument, based on the insights of Hume and Ricardo, and product of his own rhetoric and faith in the marvels of free trade. The bottom line of the red flag that we raise is that Krugman does not tell the whole story, in particular some very important implications of the 'ABC' he claims everybody should know. Implicit in his argument is the belief that trade deficits are self-correcting and that the benefits of trade do not depend on a country having an *absolute advantage* over its rivals. We argue that questioning the principle of comparative advantage is not nonsense and does not make one a "pop internationalist." Section 3 is a brief historical tour explaining the historical context in which the theory of comparative advantage was developed and which are often forgotten.

Second, and as a consequence of the above, there are other important things that need be known about trade and finance, in particular that capital flows might render the balance of payments adjustment unstable, and that there *may* be a role for trade management *if* trade depends upon absolute rather than comparative advantage. These are discussed in sections 4 and 5.

Finally, sections 6 and 7 discuss a very simple model to show why countries do care about exports. In fact, all countries in the world would love to run trade surpluses if they could, a position that runs against the doctrine of comparative advantage in its normative form. Mercantilism is a reality, not just silly economics, as Krugman may want us to believe.<sup>6</sup> His arguments can be aptly described by the phrase coined by another economist<sup>7</sup> for another historical period, according to whom "what [is] socially dangerous [cannot] possibly be true." Our purpose is to provide a more balanced guide to what the economics profession does know about trade and finance<sup>8</sup> and what one would expect an educated layman to know about the subject, a topic of increasing importance given that the Doha negotiations in the ambit of the World Trade Organization may potentially affect the lives of almost everybody in the planet.

## **2. SIX POPULAR MISCONCEPTIONS ABOUT TRADE AND COMPETITIVENESS**

To argue his point, Krugman created a fictitious statement about international economics in which he framed six misconceptions, which he argued are common. The statement is as follows:

"We need a new economic paradigm, because today America is part of a truly global economy. To maintain its standard of living, America now has to learn to compete in an even tougher world marketplace. That is why high productivity and product quality have become essential. We need to move the American economy into high-value sectors that will generate jobs for the future. And the only way we can be competitive in the new global economy is if we forge a new partnership between government and business."

Then he went one by one over the six fallacies.

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<sup>6</sup> Chang (2002) shows that most developed countries of today pursued at some point policies that might be labeled mercantilist in the past. Amsden (2001) shows that successful developing countries did too.

<sup>7</sup> See Meek (1950, p. 61).

<sup>8</sup> An early discussion of the limits to Krugman's arguments can be found in Vernengo (2000).

a. *We need a new paradigm.* Krugman argued that we do not need a new paradigm to interpret today's events. We agree on this point. The basics of trade have not changed and trade is, essentially, just another economic activity, although we might disagree with Krugman on what the basic principles of trade are. But we surely want to emphasize Krugman's statement that "everyone accepts that *occasional* dislocations are the price of a free-market economy" (our emphasis). On the contrary, quite often, more than occasionally, these dislocations are substantial and have very painful implications (e.g., unemployment). This is what countries do worry about. The argument of mainstream economics is that these dislocations are transitory (i.e., short run) and are outweighed by the efficiency gains and gains in consumers surplus. This might or might not be true, and often experience tells us that the adjustment time can be very long.

b. *Competing in the world marketplace.* Krugman argued that one of the most enduring misconceptions among pop internationalists is that countries are in competition with each other in the same way that companies in the same business compete. We do agree with Krugman also on this (Asian Development Bank 2003): strictly speaking, it is firms that compete, not countries. International trade, regarded at the country level, is not about competition but about achieving a mutually beneficial exchange. But at the firm level, international trade is about competition, though it is true that firms compete equally against other domestic firms as well as foreign firms. Certainly, from the point of view of consumers, trade is good since it offers them the possibility to have a wider variety of goods to choose from in the shelves of the supermarkets. On the other hand, when firms see that their export market share is declining, they do worry. And following Krugman's argument, if the firms of a country do not export, the country will not generate the means to pay for its imports. While the gains from trade, in the absence of any other distortions, are well understood by any student of international trade, political constraints do not always allow the implementation of trade reforms. Within any society, there are gainers and losers from such reforms and there are obstacles to designing redistributive mechanisms that ensure the sharing of gains from trade by all sections of society.<sup>9</sup>

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<sup>9</sup> We feel compelled to remind the reader that the trade theorems behind Krugman's statements, including the proof of Ricardo's comparative advantage theorem, are very complex and their seemingly straightforward conclusions depend on a number of extremely restrictive assumptions without which they do not hold. In Ricardo's example between England and Portugal, resources can be moved instantaneously without trouble or loss. Also, the two products being traded, cloth and wine, are produced in conditions of constant returns. And Ricardo did not allow overseas investment in his story. Moreover, it is common in trade theory to compare a situation of autarky with one of free trade. Real life, however, is substantially more complex. Finally, the statement that free-trade makes everybody better off is incorrect. What neoclassical trade theory says and proves is that free trade increases worldwide efficiency. Trade theory does not say, for example, that an improvement in price competitiveness in country A makes people better off in that country. It does not say either that such improvement makes people outside country A better off. The only thing the theorem shows is that the welfare of one of the two groups will improve; and that the group hurt can be more than compensated by the group whose welfare has improved. Therefore, overall, the improvement in competitiveness can potentially benefit everybody. But this is a very different statement. Moreover, standard trade theory shows that improvements in competitiveness in country A in industries that export to country B improve the latter's welfare. On the other hand, improvements in competitiveness in country A that compete with country B's exports reduce the latter's welfare.

c. *Productivity*. Krugman argues that high productivity is beneficial not because it helps a country to compete with other countries, but because it lets a country produce and therefore consume more. We have no disagreement whatsoever with this statement. The key to a country's long-run growth is productivity and this is the concept whose determinants must be understood.

d. *High-value sectors*. Krugman claims that pop internationalists believe that international competition is a struggle over who gets the "high-value" sectors. The reason is that these sectors are associated with high wages. To dismiss this belief Krugman again appeals to standard trade theory. It is certainly true that the more productive country will have a higher wage rate and therefore, whatever sector that country specializes in will be "high-value." But then Krugman argues that this does not mean that the country's high living standard is the result of being in the *right sector*, or that the poorer country would be richer if it tried to emulate the other's pattern of specialization.

We are not sure about what Krugman means. Certainly it is not a matter of deciding *ad-hoc* the sector(s) a country is going to be, especially if this degenerates into an exercise in "picking the winners." We assume Krugman means that this (i.e., the sector) is determined by the country's factor endowments, as trade theory indicates. We argue, on the other hand, that a country's production and trade pattern is determined by many other factors too. Export structures tend to be *path-dependent* and difficult to change, which has important implications for growth and development. Trade patterns are much less responsive to changing factor prices that is commonly assumed. They are the outcome of a long, cumulative process of learning, agglomeration and increasing returns, institution building and business culture. This means that the world's pattern of specialization and trade is, fundamentally, *arbitrary*: what each country produces is the result of history, accidents, and past government policies, and it is not dictated by comparative advantage given by tastes, resources and technology. Moving from a low technology (labor-intensive) structure to a high-technology (capital and knowledge intensive) one is a difficult and far from straightforward process. It is one that has involved policy interventions, e.g., Brazil, South Korea, Japan, Singapore, and even the US (Amsden, 2000). The result is that *most* products that enter international trade are created by imperfectly competitive industries. The standard argument implicit in Krugman's piece, namely that free trade optimizes resource allocation, depends also on the assumption that resources are fully employed. However, if unemployment were to arise in the process of specialization and resource allocation (in classical theory the balance of payments is assumed to be self-equilibrating) the resource gains from specialization might be offset by resource losses from unemployment. Recall that all the emphasis in the doctrine of comparative advantage is on the real economy while the monetary consequences (via balance of payments) of trade for growth are ignored. If, on the other hand, the balance-of-payments does not self-equilibrate, unemployment may develop.

The desire to specialize in the so-called high-value sectors is the result of the fear of deindustrialization that comes with globalization that those developing countries, in their strife to develop, have. This fear is a *legitimate* reflection of the idea that the international division of labor limits some countries to low-value activities that do not provide any incentive for the rest of the economy. In fact, modern theories of development acknowledge that countries can get stuck in vicious circles of poverty and traps without

showing any sign of advancement. These theories call for government support in the form of, for example, subsidies to R&D (Felipe 2003).

e. *Jobs*. Krugman argues that the level of employment is a macroeconomic issue, depending in the short-run on aggregate demand and in the long run on the *natural rate of unemployment*, with microeconomic policies like tariffs having little net effect. Krugman argues that trade policy should be debated in terms of its impact on efficiency, not in terms of phony numbers about jobs created or lost. Again, we agree with the first part of the statement, namely that, in general, employment is a macro issue. But we disagree with the statement that employment depends on the natural rate of unemployment, one of the most powerful (and damaging) ideas in mainstream macroeconomics that states (in a simplified version) that there exists an unemployment rate at which inflation accelerates. The implication of this concept is that if there is a positive *natural* rate of unemployment it is because workers refuse to accept the equilibrium wage rate, or because non-market forces such as labor unions prevent the wage rate from falling to its full employment equilibrium point. Therefore, governments should not pursue full-employment policies (e.g., via monetary policies) because if unemployment falls below the natural rate, inflation will increase. Moreover, inflation will accelerate as long as unemployment remains below the natural rate. If rational expectations are included in the model, there is no trade off at all. The policy message is clear: the unemployment rate should not be allowed to fall below the natural rate of unemployment and macroeconomic policy is bound by an inflation constraint.

We believe that not only there is nothing *natural* about the natural rate, but also empirically there is no set unemployment rate at which inflation accelerates (Staiger et al. 1997). And yes, there is evidence that trade policies do affect employment, and that trade reform has important implications for income distribution. Standard arguments supporting trade reforms emphasize issues of efficiency: welfare is maximized when there are no trade distortions. This is true, however, if there are no terms-of-trade effect and in steady state. Otherwise the adjustment costs can be very large (Mitra 2003, Matusz 2003). More precisely: While it may be possible to argue that the long-run impact of trade on employment is negligible, one can make a strong argument that the short-run effects can be substantial [...] As Baldwin et al. (1980) note, it is 'bad economics' to ignore these potential costs since the near present (when costs are incurred) counts more heavily than the 'long run' (when most benefits accrue) as long as economic agents discount the future" (cited in Matusz 2003, p.100).

f. *A new partnership*. Krugman argues that since pop internationalists believe that firms are competing with foreigners instead of with each other, the conclusion is that they advocate government's support for the country's firms against foreign rivals. Krugman correctly argues that a country's firms compete as much against other domestic firms as against foreign firms; and that government support of an industry may help that industry but it also draws resources away from other domestic industries. Krugman points out that, due to the presence of external economies, it may be justified to prefer some industries to others, although this would be true too in a closed economy.

### **3. THE PERILS AND PITFALLS OF THE THEORY OF COMPARATIVE ADVANTAGE: SOME ECONOMIC MYTHS THAT EVERYBODY SHOULD BE AWARE OF**

This section provides a brief summary of the historical context in which Ricardo wrote about comparative advantage, and which is usually missed in standard textbooks and discussions. We think it is important.

At the time Ricardo wrote he was right that England had a comparative advantage in making cloth and Portugal in making wine. But this was not the result of economics, much less that it proved the superiority of free trade (Magdoff 1978; Sideri 1970). History reveals that the comparative advantages of England and Portugal had their origin not so much in economics as in politics. "The comparative advantage that mattered was rooted not in soil or labor productivity, but in the superiority of British sea power and in Portugal's inability to hold on to its overseas empire without the protection of the British navy" (Magdoff 1978, p.156). Magdoff describes in detail the economic and political relationships between England and Portugal, going back to the fourteenth century. The fate of the two countries was sealed in a series of treaties between the seventeenth and eighteenth centuries, where England, in exchange for its military help to Portugal to maintain its colonies, imposed the conditions which enforced an international division of labor, "celebrated up to this day as a prime example of the virtues of objective and independent economic laws" (Magdoff 1978, p.156). These treaties fostered Portugal's economic dependence on England by opening the door English ships in Portugal and in Portugal's African and Indian territories. Moreover, they gave special privileges to English traders in Portugal, and required that Portugal buy all its ships from England.

Portuguese dependence on England achieved its maximum through the Methuen Treaty of 1703. The background to this Treaty is as follows. During the last years of the seventeenth century, Portugal had developed a protectionist policy, which materialized in forbidding its people to wear foreign cloth. Simultaneously, Portugal had also made successful efforts to stimulate the domestic manufacture of cloth. This affected negatively British manufacturers and merchants. At the same time, while British people preferred the lighter French wines to the heavier Portuguese wines, wars with France and France's own protectionist policies induced Britain to search for other sources of wine. Finally, gold had been discovered in Brazil. The Methuen Treaty stipulated that Portuguese restrictions on English cloth and woolen manufactures were lifted. In return, Britain guaranteed a lower tax on Portuguese wine than on French wine. The result was obvious: Portuguese cloth manufacture was strangled in its infancy. "Free trade" ruined Portuguese industry. Instead of developing a dynamic garment and textile industry, Portuguese capital flowed massively into winemaking, affecting even investments in corn and other foodstuffs. On the other hand, England expanded its garment and textile industry and the achievement of as a larger-scale production meant a reduction in costs. Indeed, English competitiveness in the sector increased. The discovery of gold in Brazil also played its role in these arrangements. In time, the Portuguese economy, with its lack of a well-developed manufacturing sector, became very dependent on England. While trade between the two nations increased, Portugal's imports of goods from England exceeded the latter's imports from Portugal. Moreover, a great share of ocean trade between the two nations was transported in English ships, thus intensifying Portugal's unfavorable balance of payments. How was this settled? The gold mined in Brazil was used to settle Portugal's accounts with England. This had another effect: it helped London become the world's bullion market, and to eventually take over the role of main financial market from Amsterdam. In other words: dominance in trade was closely related to dominance in financial markets.

This brief historical tour indicates that there is much more about the development of the theory of comparative advantage than standard textbooks tell. More important perhaps than the Ricardian example of trade between England and Portugal in historical perspective is the relation between England and Asia. In fact, Portugal – and to a lesser

extent Spain – Holland and England, had successfully dominated the trade routes to the East. As noted recently by Pomeranz (2000), until around 1800 the living standards in the West, including England, were not very different from those in the East, particularly in PRC. In fact, if anything, trade with Asia – starting with the spice and silk routes dominated by Arab, Venetian and Genoese merchants and up to the nineteenth century – was the result of Western demand for the more developed and sophisticated Eastern goods (e.g., silk and cotton textiles, species, porcelain, rugs, etc.). Further, Pomeranz (2000) shows that several measures of well being demonstrate that the PRC was ahead of Europe. Grain and sugar consumption was higher as well as caloric intake. Furthermore, wages were in general higher, and in particular, Chinese textile workers received higher wages. More importantly, life expectancy measures show that PCR was not lagging behind. This is the inescapable conclusion one must derive from Maddison`s (2000, pp. 29-41) data too.

The new emphasis on the similarities between Western Europe and the PRC up to the late eighteen early nineteen-century is certainly important. However, the emphasis on similarities should not obscure the big difference associated with Western European dominance of long distance trade. The tables below show that between the great discoveries and the Industrial Revolution Western Europe maintained its importance in international trade, at around fifty percent, while Asia lost its competitive edge.

Table 1 Trade patterns circa 1500

Origin	Destination			
	Asia	Europe	Africa	World
Asia	29	20	1	50
Europe	14	30	1	45
Africa	2	2	1	5
World	45	52	3	100

Source: Ferrer, 1996.

Table 2 Trade patterns circa 1800

Origin	Destination				World
	Europe	Asia	America	Africa	
Europe	20	8	10	2	40
Asia	15	15	–	–	30
America	15	–	5	–	20
Africa	1	2	6	2	10
World	51	24	21	4	100

Source: Ferrer, 1996.

The dominance in long distance trade reflects, despite revisionists' claims, a more advanced naval technology, and more importantly, more developed weaponry (Landes, 1998). Not only did Western Europe dominate the trade routes that connected it with Asia, but also Portuguese, Dutch and British ships dominated a good part of intra-Asian trade. Between the great discoveries and the Industrial Revolution, the European share in total world trade increased – in particular because intra-Asian trade and intra-American trade was dominated by Europeans– while that of Asia decreased drastically. However, if Asia was not lagging behind technologically and its living standards were

close to those on the West, how did they lose their trade position?<sup>10</sup> According to Krugman's story the trade position had to be a reflex of the technological situation.

The analysis above leads us to conclude that comparative advantage was "historically created" as the result of colonialism, wars, nationalist rivalries and military power. And, as Magdoff points out, "this is but a mild example of the origins of the international division of labor: it occurred, after all, between two Christian, colonizing powers" (Magdoff 1978, p.159). And according to Cohen: "In order to fully grasp the nature of this drama, let us examine the *Southern part* of Ricardo's program" (Cohen 1998, p.35; italics added). When England started specializing in manufactures and industrial production, it had to find countries that were willing to import. Portugal was one of them, but it was very small. Other markets were needed. The other large and powerful countries of Europe were trying to catch up with Britain and were also developing their industrial base. "In practice, trade could occur only with countries that were under British rule. When India was flooded with British products, the result of was total destruction of its industrial base" (Cohen 1998, p.36). In the early nineteenth century, India was a net exporter of textiles and its cottage industry was well developed. However, by the end of the century, three-fourths of the textiles consumed in India were imported from England. "But the tragedy did not stop here" (Cohen 1998, p.36). India produced wheat and other food crops. However, England preferred to import these from the United States, with the consequence that it left India with exports of cotton, jute and indigo. This meant that India was forced to specialize in the cultivation of products that did not guarantee its own food supply. India saw itself having famines, importing basic products, and each time the world's state of affairs was unfavorable, not affording to import food. Magdoff, quoting historian Carlo Cipolla, summarizes all this state of affairs brilliantly:

"The story of the East India silks and calicoes that were imported into England and caused difficulty for the English textile industry is so well known that it does not need to be told here. It was fortunate for England that no Indian Ricardo arose to convince the English people that, according to the law of comparative costs, it would be advantageous for them to turn into shepherds, and to import from India all the textiles that were needed. Instead, England passed a series of acts designed to prevent importation of Indian textiles and some "goods results" were achieved" (Magdoff 1978, p.159)

There is one more anecdote to add (Cohen 1998, pp.36-37). The British discovered that the Indians were good at cultivating poppy seeds, for which the main market was nearby PRC. The Chinese authorities were aware of the terrible effects of opium and wanted to forbid its trade. What did England do? It declared war on PRC in order to force it to open its ports to poppy imports. PRC had to give in and opium was free to enter. Liberalism was enforced in most of what used to be called Third World. Unequal Treaties were signed between 1810 and 1850 mainly as a result of British pressure (Bairoch 1993, p. 41).<sup>11</sup>

While reading standard textbooks one is implicitly led to believe that Ricardo wrote pages and pages about his theory of comparative advantage, and that this was a central

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<sup>10</sup> Several technological innovations, such as the compass, the multi-mast boat, gunpowder, paper money and the printing press were in fact Chinese.

<sup>11</sup> One of the main consequences of the forced liberalism of the Third World was late industrialization. Bairoch (1993, p. 53) correctly points out that "there is no doubt that the Third World's compulsory economic liberalism in the nineteenth century is a major element in explaining the delay in its industrialization."

theme in his writings. Neither is true. Ricardo was concerned with the dynamic process of capital accumulation and he analyzed this issue in the context of economic classes. The key questions in his writings were: how is surplus extracted, who gets it, and what is it used for (i.e., questions about distribution). Ricardo lived between the end of the eighteenth century and the beginning of the nineteenth. At this time, England was not self-sufficient in food production, and Ricardo saw capitalists' profits being reduced by the rising costs of corn (generic for grain, mostly wheat, production). This situation benefited the landlords, who would spend their rents on luxury consumption. Ricardo argued that the key to growth lay in the greatest possible accumulation of capital. This would induce the demand for labor to rise, leading to a tendency for the wage rate of the working classes to be above the subsistence level. This would increase consumption. But this depended, of course, on food being cheap, *corn freely imported*, and rents low so that the landlords were unable to suck up most of the surplus for luxury consumption.<sup>12</sup> This is the historical context in which Ricardo included no more than a couple of pages on comparative advantage. Ricardo saw the incipient capitalist mode of production as the most advantageous for the creation of wealth, and thus saw the importance of capitalists in this process. Ricardo was ruthless toward the English aristocracy because they were siphoning the surplus due to the high prices of corn.<sup>13</sup> The solution was to import corn. When Ricardo set out the case against protection, he was supporting British economic interests.

Therefore, the failure to understand Ricardo's theory of distribution has led to people to misunderstand what was important to Ricardo about foreign trade. As Walsh indicates "Ricardo did not invent the idea of comparative advantage, since it was current in his day and in any case it did not bear on the case of foreign trade which dominated all his thinking: the influence of a low price of imported corn (a 'necessary') upon profits" (Walsh 1992, pp. 15-16). It was *obvious* to Ricardo that England had an *absolute* advantage in manufactures. On the other hand, England had to cultivate corn on hillsides of very low quality. Ricardo reasoned that importing corn would lower the cost of the real wage and thus raise the rate of profit. Moreover, importing more cheaply a luxury like wine would be nice for those who drink it, like the landlords, but since wine was not a component of the working class basket, this would have no effect on the real wages and hence, no effect on profits. In other words: Ricardo's analysis of the effect of importing corn, and in general of foreign trade, has to be understood in the context of the effects on the rate of profit and his theory of distribution. Neo-classical trade models, unfortunately, obscure these questions.

#### **4. BALANCE OF PAYMENTS ADJUSTMENT AND COMPARATIVE ADVANTAGE**

It is surprising the power that ideas have in shaping economic policies. As Keynes famously said, policy makers that consider themselves pragmatic are more often than not slaves of some defunct economist. Most problems we pointed out above regarding Krugman's conclusions can be ultimately blamed on his conviction on the self-adjusting nature of the balance of payments and the role of comparative advantage in determining

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<sup>12</sup> In Ricardo's theory of distribution there is an ordering to receive compensation: first, wages are paid to the workers; second, rents are paid to the landlords; and finally, capitalists get the leftovers, in the form of profits.

<sup>13</sup> Ricardo eventually became a Member of Parliament (MP) and was aligned with the so-called Radicals. His politics was far more progressive than usually assumed. For a full discussion see Milgate and Stimson (1991).

trade patterns. Both views are the product of ideas of defunct economists, namely: David Hume and David Ricardo.

The theory of balance of payments adjustment has gone in full circle, from the automatic adjustment views of David Hume's specie-flow mechanism, to the Keynesian interventionism of the neoclassical synthesis, to the revival of hands off views within the monetary approach to the balance of payments.<sup>14</sup> David Hume developed the price-specie-flow mechanism not only as an interpretation of the balance of payments adjustment process, but also as an argument against the mercantilist defense of government intervention, as much as Krugman's views on the self-adjusting nature of the balance of payments are more generally a critique of what he sees as the neo-mercantilism of the pop internationalists.

According to the price-specie-flow mechanism the balance of payments is self-adjusting. In a fixed exchange rate system, if a country runs a trade deficit, then there will be an outflow of capital to pay for the deficit, which will lead to deflation in the deficit country, and to inflation in the surplus country. As a result of the fall of prices in the deficit country, its exports will become more competitive, thus restoring the trade balance equilibrium. In other words, capital flows eliminate any trade imbalance. The adjustment depends completely on price variations, and the balance of payments is essentially a monetary phenomena. Under a flexible exchange rate system, the currency of the country that has a deficit depreciates, cheapening the foreign currency equivalent of the product price. The process is assumed to continue until trade is balanced.

Many authors have argued, however, that the monetarist mechanism does not take place in practice. It has been argued, for example, that the primary effect of a money outflow is to make the economy less liquid, which leads to increases in interest rates. If investment is sensitive to interest rates, output and employment may fall instead of prices. The increase in interest rates will attract short-term capital into the country. This way, the trade deficit will be covered in the capital account. But this cannot be a definite solution since it transforms a trade imbalance into one of international indebtedness. And if the government prevents interest rates from rising, then it must support the currency by using its reserves, or by restricting imports, or by attracting long-term capital flows. But if the root of the trade imbalance lies in higher unit costs, and this is not directly tackled, the problem will remain. The other possibility that standard theory contemplates is depreciation-devaluation. But this measure also has its problems. For one, devaluations lower export revenues (the J-curve effect). Second, the Marshall-Lerner condition indicates that, for the trade balance to improve following a devaluation, the sum of export and import price elasticities must be greater than one. Empirically we know that devaluations do not work.

Modern versions of the specie-flow emphasize the role of stock and flow equilibria and emphasize intertemporal horizon decision-making. Hence, the balance of payments only needs to adjust over several periods. Deficits can persist for example if the central bank raises the domestic interest rate to attract capital flows. However, this is only sustainable up to the point where foreign investors wish to invest into the domestic economy. That is,

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<sup>14</sup> Hume's specie-flow explains the balance of payments adjustment with a fixed exchange rate. However, the idea that the balance of payments adjusts automatically, and that the process depends essentially on monetary variables stands with a flexible exchange rate. Milton Friedman, a defender of flexible exchange rates, would be the main advocate of this idea.

the balance of payments flow disequilibrium can be maintained if foreign investors are willing to hold domestic denominated assets (stock). Repayment implies that the initial deficit has to be reversed and surpluses generated. In other words, modern versions of the specie-flow would allow the balance of payments to be smoothed out over several periods as a result of the existence of international capital markets.

The idea that the balance of payments is self-adjusting needs to be complemented by the proof that free trade is mutually advantageous for the parties involved for a complete defense of the *laissez faire* doctrine. For if free trade led to inefficient specialization patterns, the fact that deficits are self correcting would be of no importance. The notion that free trade leads to efficient allocation of resources was developed by David Ricardo, and is known as the principle of comparative advantage (recall the discussion above). As is well known, the principle of comparative advantage says that a country should specialize in the production of the good in which it has a lower opportunity cost (measured in terms of unit labor requirements) *vis-à-vis* another good. Modern versions of the principle of comparative advantage imply that a country should specialize in the production of the good that uses intensively a resource that is abundant in the country. For example, developing countries in Asia that are abundant in unskilled labor relative to the developed countries – more abundant in skilled labor – should specialize in the production of goods that use unskilled labor intensively.<sup>15</sup>

The conjugation of specie-flow and comparative advantage should be soothing for those that have faith in the abilities of the market. Not only disequilibrium is temporary, but also if left to themselves markets would lead to a pattern of specialization that is efficient. However, both propositions depend on a basic assumption, namely: full employment.

For one thing, outflows (inflows) of capital may not lead to deflation (inflation).<sup>16</sup> If prices were relatively rigid in the short run, a more logical consequence would be a change in the level of economic activity. For example, in the surplus country the inflow of capital would only lead to inflation if the economy were already working at full capacity. If that is not the case, then an increase in the level of output and employment will ensue. The opposite would happen in the case of a deficit country. This is what Keynes had in mind when he argued that mercantilists, after all, were on to something.

Also, comparative advantage presupposes that when a country opens up the patterns of specialization change painlessly, that is, workers dismissed in an uncompetitive activity

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<sup>15</sup> One result of this version of comparative advantage, known as Hecksher-Ohlin, is that if countries liberalize trade, then the demand for unskilled labor should increase in the developing world with respect to skilled labor leading to an improvement in income distribution. The opposite would happen in developed countries. The evidence on the Hecksher-Ohlin is mixed, while it fits some Asian countries it fails in Latin America. Also, in developed countries, although there has been an increase in the skilled to unskilled wage ratio, other causes than trade liberalization have been pointed out as more relevant.

<sup>16</sup> It is important to note that these results depend on the assumption of a fixed exchange rate, and a relatively underdeveloped international financial market. In this case a deficit country would have to pay for the excess imports with reserves (presumably gold), and the reduction of money translates into deflation. If exchange rates were flexible, then the outflow would be followed by a depreciation of the currency that would also lead to a substitution effect, increasing exports and reducing imports. In either case, the existence of a developed international financial market would allow the deflation or the depreciation of the domestic currency to correct the balance of payments imbalance over several periods.

would find a job in another more competitive activity. Everybody can find a job provided labor markets are flexible enough. The full employment level is often referred to as the natural rate of unemployment. As indicated above, the natural rate – that is so crucial for the specie-flow cum comparative advantage doctrine – has been conspicuous for its absence in the 1990s. In the early 1990s in the US most macroeconomist agreed that the natural rate was around 6 per cent. If unemployment fell below that rate, then the economy would overheat and inflation would follow. Yet, by the mid-1990s unemployment had fallen below 4 per cent and inflation was nowhere to be seen. Alan Greenspan was praised by the market for not hiking interest rates when unemployment rates started falling. Some economists argued then that the natural rate had fallen to around 4 per cent. As Bob Solow once said the natural rate is whatever economists want it to be.

In fact, to understand the importance of adjustments in the level of activity one does not need to make a big effort. Balance of payments crises (e.g., the Latin American debt crisis of 1982, the Asian Crisis of 1997, etc.) are often followed by severe contractions of the level of activity and increasing levels of unemployment. Further, as the contraction helps to reduce trade imbalances by reducing the level of imports, patterns of trade are also affected. Usually countries cut the imports of superfluous goods, and maintain imports of intermediary goods essential for production. These changes are seldom – if ever – determined by changes in relative prices.

In sum, we argue that a crucial element in Krugman's view depends on a proposition that is – to say the least – difficult to defend in theory, and that has scant evidence in its support. Full employment or tendencies towards it are not a common feature of modern economies. So one could ask what would be the consequences of abandoning that assumption, and assuming a more pragmatic macroeconomic theory for the theory of balance of payments adjustment and trade specialization. That is what we propose to answer in the next section.

## **5. AN ALTERNATIVE VIEW**

Once we admit that unemployment may be a relevant feature of the economy, then the possibility that the balance of payments becomes unstable and that trade patterns depend on *absolute advantage* have to be considered as likely explanations of the functioning of the international economy. The instability of international financial markets, and the role of trade and industrial policy are then seen on another light. If one had to determine who are the defunct economists that 'enslave' the defenders of this alternative view, then John M. Keynes and Adam Smith are the most probable culprits.

It is rather curious that, in the context of a single nation, standard economic theory assumes that competition is ruled by the law of absolute advantage (or costs), that is, firms with the lower unit costs enjoy an absolute competitive advantage. Competition between countries, however, is ruled by comparative advantage. This is due to the existence of different national currencies. Trade adjustment is done through changes in the real exchange rate. Conventional trade theory argues that neither technological backwardness nor high costs are a disadvantage in international trade. Real exchange rates always move in such a way as to make all trading partners equally competitive so that no country will suffer persistent trade deficits or enjoy persistent trade surpluses. The trouble with all this is that it does not fit the facts. Why can't it be that international trade operates in essentially the same manner as national trade, i.e., ruled by absolute costs, as Adam Smith argued, so that producers with lower unit costs are able to cut

prices and expand market shares at the expense of their rivals? In this case, producers with the lowest costs will be the ones able to drive the market price of products. Isn't it possible that international competition does not operate as an equalizer, and that, in fact, it rewards the low-cost producer, the same competition within a nation?

According to the conventional view international financial markets are well behaved. Capital flows smooth out the pains of balance of payments adjustment, which are resolved by changes in relative prices. Even if one admits changes in the level of activity, these are seen as temporary, since the economy eventually reaches the natural rate. In fact, capital flows are often seen as the result of trade (real) imbalances, and do not have a life of their own. That might have been a reasonable explanation of the functioning of international financial markets in the late eighteen or early nineteen centuries, when Hume and Ricardo wrote about the subject.<sup>17</sup> This view, however, is less appealing in the twenty-first century.

Joseph Stiglitz (2002) has revived the Keynesian view that international financial markets may very well be unstable and prone to crises. For example, a country may receive inflows of capital as a result of the increasing confidence of international financial markets on its ability to grow – say for example, that the main reason is a recent history of fast growth. The inflows of capital lead to an increase of imports, and also to an appreciation of the domestic currency. Both effects tend to lead to a worsening of the trade account.<sup>18</sup> The trade deficit is not necessarily bad – as Krugman correctly points out. If these inflows were used to buy machines and equipment and lead to higher investment and higher productivity, one would expect that exports in the future would more than compensate the initial deficits. In this case, the inflows would be sustainable and there would be nothing to worry about.

On the other hand, if the inflows are used for consumption, and there are no prospects of higher exports, then one might be in trouble. Also, the appreciation of the currency, caused by the capital inflows, may force competitive firms out of business. This has hardly anything to do with lack of comparative advantage, since the only reason for failure is an appreciated exchange rate. Often countries in this situation would hike interest rates to attract capital flows and allow the trade deficits to continue for a while. This only makes things worse, since continuous inflows keep the exchange rate appreciated, and the high interest rates compress domestic investment. A trap of low growth and an unsustainable balance of payments are the results. The final crisis is usually triggered by some outside event that leads to capital flight and depreciation of the domestic currency.

Depreciation, however, is also contractionary. A depreciation means that those with debts in foreign currency (and usually revenues in domestic currency) have a prospect of a higher debt-servicing burden. Also, it is not uncommon to encounter that international debts were contracted short, while revenues were long. Hence, the currency and term mismatches mean that debtors are bankrupted, leading to lower

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<sup>17</sup> That was not Ricardo's view, however. Marcuzzo and Rosselli (1986) make a convincing case that Ricardo did not believe in Hume's specie-flow mechanism.

<sup>18</sup> As one can see, in this view, the trade account is the result of decisions taken in the capital account of the balance of payments.

levels of activity, lower growth and higher unemployment.<sup>19</sup> It is the contraction of output, and the consequent fall in imports, that helps adjust the balance of payments (e.g., what happened during the East Asian financial crisis). Debt restructuring, unemployment and lower rates of growth for long periods tend to follow.

In other words, international financial markets can make the balance of payments adjustment process quite painful. That was the reason why Keynes advocated capital controls during the Bretton Woods conference. It is also behind the argument put forward by Stiglitz (2002) that the two countries that escaped the Asian Financial Crisis were China and India, the two countries with the more comprehensive foreign exchange controls. Or, more dramatically, this is also the reason why *The Economist* – a bastion for defenders of free trade in goods, services and capital flows for decades – has finally admitted regarding liberalization of capital flows that “the anti-globalists are on to something,” and that in this light “for some countries, imposing certain kinds of control on capital will be wiser than making no preparations at all,” (Crook, 2003). Even Krugman (1998) has advocated capital controls in the face of severe balance of payments crises.

One may then ask: if capital flows have an important impact on the trade account, and countries may get in serious balance of payments crises, what then determines a country’s pattern of specialization? Adam Smith, long ago, gave a reply that does not depend on the self-adjusting nature of the balance of payments. As it is well known, for him the wealth of Nations depended on the division of labor (technical progress). And the latter depends on the extension of the market.

Let’s say that a certain economy maintains a relatively closed capital account. Hence, the country is protected from inflows of hot money – that tend to leave when they are needed. In this economy – in particular if domestic markets are relatively small – the search for foreign markets generates directly higher rates of production and output. More importantly, export orientation – which should not be confused with openness – by forcing the economy to work at near full capacity promotes technical progress. As the saying goes “necessity is the mother of invention.” That is, economies that are under pressure of increasing demand need to create new processes of production, new forms of organization and new products to be ahead of demand. The technical developments in turn generate higher levels of output and income, which translate in a new expansion of the demand, and a cumulative process of accumulation follows.<sup>20</sup>

According to this view policies that promote full employment and demand growth are desirable, since they are self-reinforcing. One must note, however, that we presumed that the capital account tends to be relatively closed for the cumulative causation process to work. If that were not the case, then interest rates would be on average higher to attract capital flows and/or avoid capital flight, leading to negative effects on expenses. Also, another caveat is important: macroeconomic policies that promote full employment, as well as trade and industrial policies, *may* all help launch the cumulative process of accumulation, but those policies should not be equated with unmitigated protectionism. However, *selective* management of trade and industrial policies should not be ruled out, since developed countries used those instruments in the past.

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<sup>19</sup> Banks are hit particularly strong. The result is what is often referred to as the twin crises (banking and balance of payments).

<sup>20</sup> One should note that Krugman is not unaware of the notion of cumulative causation. In fact his work on economic geography delves into the topic favorably.

## 6. WHY COUNTRIES CARE ABOUT EXPORTS

Classical economists since Adam Smith excoriated the Mercantilist school of the sixteenth and seventeenth centuries for emphasizing the importance of exports over imports and the accumulation of foreign reserves in the form of coins and precious metals as a measure of a country's wealth and power (Keynes 1936, Buchholz 1999, Routh 1989). For the Mercantilists,<sup>21</sup> domestic prosperity was directly dependent on a competitive pursuit of markets and an appetite for precious metals. On the other hand, Smith believed that real wealth should be gauged by the standard of living of households, and that wealth must be measured from the viewpoint of a nation's consumers.

According to Krugman (1996, p.18), the mercantilists believed that countries compete with each other the same way that corporations do. And regarding trade, they believed that its ultimate purpose was to generate exports, which create jobs. The mercantilists were not necessarily protectionists. In fact, they supported free trade and were willing to lower their trade barriers to offer concessions in return for access to other countries' markets. The classical (i.e., Ricardian) and neoclassical (Heckscher-Ohlin) models of trade tell us, on the other hand, that the true purpose of international trade is imports, not exports. The most important result of these models is that a country should specialize in the production and export of the good in which it has a relative comparative advantage. This way, international trade is potentially welfare enhancing since it increases efficiency.

Despite the above, the view from the street is that it is "better" for a country to run a trade surplus than a trade deficit and there is no doubt that there is a peculiar advantage to a country in a favorable balance of trade, and grave danger in an unfavorable balance, particularly if it results in a loss of reserves. The reality is that countries like China, Germany, Japan, Hong Kong, province of China, Singapore, South Korea, or Taipei are seen as successful precisely because they have run trade surpluses for years and accumulated massive foreign reserves. Today, PRC runs a positive trade balance and holds a record \$US 350 billion in foreign reserves.<sup>22</sup>

Are these countries simply wrong in terms of economic theory, or is there a rationale for such behavior? The purpose of this section is to show that indeed there is a rationale behind the popular view that countries do prefer trade surpluses, and a reason why countries pursue them in real life. In this sense, the Mercantilists were, after all, on to something. However, with the domination of the classical school of thought we have been brought up to believe that Mercantilism is little more than nonsense (e.g., see Krugman 1996). What is interesting is that this is a position held mostly within (orthodox) academic circles, where Mercantilism is viewed as absolutely groundless (except perhaps on a very short view), since the mechanism of foreign trade is self-adjusting and attempts to interfere with it are not only futile, but greatly impoverish the citizens of the countries that practice them because they forfeit the advantages of the international division of labor. Mercantilism might not be the "best" option for the world from a

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<sup>21</sup> One should note that neo-mercantilist ideas survived the onslaught of classical and neoclassical criticism. Alexander Hamilton, Friedrich List, the German Historical School, Raul Prebisch and others defended policies that resemble in part the mercantilist views.

<sup>22</sup> Of course it is legitimate to ask if maintaining such high level of reserves is necessary and wise.

“theoretical” point of view. But it is not nonsense, at least some aspects of it. And since it is what several countries do in practice, it is worth taking a look at it.

It is also worth mentioning that Keynes's *General Theory* sees Mercantilism in a positive light. A few important misconceptions about Mercantilism pointed out by Keynes (1936) are as follows:

1. “The Mercantilist thought never supposed that there was a self-adjusting tendency by which the rate of interest would be established at the appropriate level. On the contrary, they were emphatic that an unduly high rate of interest was the main obstacle to the growth of wealth; and they were even aware that the rate of interest depended on liquidity-preference and the quantity of money” (p.341).
2. “The Mercantilists were aware of the fallacy of cheapness and the danger that excessive competition may turn the terms of trade against a country’ (p.345)
3. “The Mercantilists were the originals of “the fear of goods” and the scarcity of money as causes of unemployment which the classicals were to denounce two centuries later as an absurdity” (p.346).
4. “The Mercantilists were under no illusions as to the nationalistic character of their policies and their tendency to promote war. It was national advantage and relative strength at which they were admittedly aiming” (p.348).

One may claim that Keynes overstates the theoretical sophistication of the Mercantilists arguments. However, it is clear from his assessment that the opposite view – that makes Mercantilists a bunch of greedy simpletons – is less accurate. The following section provides some justification for neo-mercantilist policies in a modern guise.

## 7. EXPORTS AND PROFIT REALIZATION

We turn now to a very simple model that justifies why countries do care about having trade surpluses. The foregoing argument follows Kalecki (1991).<sup>23</sup> Kalecki started from the definitions (identities) of output from the demand and income sides. The first one is  $Y = C + I + G + X - M$ , where  $Y$  denotes output,  $C$  is private consumption,  $I$  is private investment,  $G$  is government expenditures,  $X$  denotes exports and  $M$  denotes imports. Private consumption can be disaggregated into workers consumption ( $C_W$ ) and capitalists consumption ( $C_K$ ), i.e.,  $C = C_W + C_K$ . The identity from the income side is  $Y = P + W + T$ , where  $P$  denotes after-tax profits,  $W$  is the wage bill and  $T$  denotes taxes. Wages are either consumed ( $C_W$ ) or saved ( $S_W$ ), i.e.,  $W = C_W + S_W$ . Combining these expressions, all of them identities, leads to an accounting identity for profits:

$$P = C_K + I - S_W + (G - T) + (X - M) \quad (1)$$

Expression (1) indicates that the profits that the owners of capital receive equal the sum of their own consumption and investment spending ( $C_K + I$ ) minus workers' savings ( $S_W$ ) plus the government deficit ( $G - T$ ) and the trade surplus ( $X - M$ ). It must be emphasized that expression (1) is an identity, not a behavioral equation. In this sense,

<sup>23</sup> For a similar model see Blecker (1999).

every economy must satisfy it ex-post, i.e., no matter the behaviors of each variable on the right-hand side. In this sense, it can be viewed as a constraint on the economy.

Economists like Kalecki and Kaldor assumed that workers consume all their wages and, therefore, do not save ( $S_W = 0$ ). With this in mind, expression (1) indicates, first, that capitalists get in the form of profits (P) what they spend on their own consumption ( $C_K$ ) and private investment (I). Moreover, a trade surplus ( $X - M$ ) and/or a government deficit ( $G - T$ ) enable capitalists to earn “extra” profits in excess of their own expenditures. Why does a trade surplus add to capitalists’ profits? A trade surplus represents the excess of national income over domestic expenditure (i.e.,  $Y - C - I - G$ ) due to the excess of exports over imports. This difference can be considered “extra” profits. On the other hand, a government deficit represents the excess of private sector earnings over private sector spending, financed by private lending to the government.

As it has already been emphasized, expression (1) is an identity. However, Kalecki implied that there was causality from the right to the left-hand side, that is, from the expenditures that generate profits to the amount of profits realized. To argue his point, Kalecki offered a very simple model of profit determination. To this purpose, as noted above, he argued that worker’s savings were a constant, often assumed zero. Therefore,  $C_W = W$ . Also, he specified the following function for capitalists’ consumption:

$$C_K = c + \sigma P \quad (2)$$

that is, a linear function of profits (P) where  $\sigma$  denotes the capitalists’ propensity to consume out of profits. By substituting these two expressions for workers’ and capitalists’ consumption into expression (1) we obtain the solution for the equilibrium level of profits, namely:

$$P = \frac{c + I - S_W + (G - T) + (X - M)}{1 - \sigma} \quad (3)$$

It is obvious that expression (3), not an identity any more, is a multiplier formula with a profit multiplier of  $1/(1 - \sigma)$ , and with all the variables in the numerator taken as given or predetermined. The equilibrium level of profits occurs at the point where the demand for profits (the right-hand-side of expression (1), and where capitalists’ consumption is given by equation (2)) equals profit income (P). This equilibrium is stable as long as  $\sigma < 1$ .

Equation (3) can be transformed into a solution for total income (Y) using the identity for the profit share in national income that  $\pi = P/Y$ . This yields:

$$Y = \frac{c + I - S_W + (G - T) + (X - M)}{(1 - \sigma)\pi} \quad (4)$$

There are several important aspects worth commenting on behind these results. First, equation (4) indicates that the equilibrium level of national income depends on its distribution between wages and profits via  $\pi$ . Second, equation (4) shows that the level

of national income is inversely related to the profit share. This is referred to *stagnationism* or *underconsumptionism*, implying that a redistribution of income towards profits causes output to decline. Or, from the opposite point of view, economic expansion is “wage-led”, in the sense that redistribution towards wages, i.e., increase in  $(1-\pi)$  leads to an increase in income. It must be emphasized that this important result follows from the fact that in this simple model there is only one macroeconomic consequence of a redistribution of income towards profits, namely, to raise the marginal propensity to save, which has a contractionary effect.<sup>24</sup> Third, equation (4) also indicates, assuming a given level of workers’ savings and a given budget deficit, that an increase in the trade surplus  $(X-M)$  shifts the demand for profit income as the higher trade surplus must be matched by higher capital outflows which must be financed out of higher profits. In equilibrium, the higher aggregate demand implied by the increase in the trade surplus generates additional sales of firms that increase their profits until a new equilibrium level of income profit (e.g.,  $P'$ ) is attained. How much is this increase in profits? From equation (3) it follows that  $\Delta P = \frac{\Delta(X-M)}{1-\sigma}$ , where under the assumption that  $\sigma < 1$ ,  $\Delta P > \Delta(X-M)$ . This

is because capitalists’ consumption rises endogenously, which creates both additional demand for profit finance and extra aggregate demand (which induces the necessary profits).

The last point above implies that there exists a rational basis for countries to achieve and maintain trade surpluses for these tend to increase the profits of domestic firms. Certainly this model is very simple and, as pointed out in the footnote above, the result that there is an inverse relationship between the level of income and the profit share may change in a more complicated model. But at the same time, this simple model provides with some intuition as to why, in real life, countries pursue trade surpluses.

Consider again equation (4) above, which shows the inverse relationship between output and the profit share. If firms use a simple mark-up model where prices ( $p$ ) are set according to a mark-up ( $\tau$ ) on wages ( $w$ ) adjusted by productivity ( $Y/L$ ), i.e.,  $p = (1 + \tau)[w / (Y/L)]$ , it implies that capital’s share can be written as  $\pi = \tau / (1 + \tau)$ , referred by Kalecki as the degree of monopoly. Assume a situation where workers win large wage increases and firms respond by cutting their mark-ups, while still raising prices to some extent. Under these circumstances, we have to consider two offsetting effects. First, the profit share  $\pi$  will fall. As income is redistributed to workers, i.e.,  $(1-\pi)$  increases and these have a higher marginal propensity to consume than capitalists, equation (4) indicates that the multiplier  $1/(1-\sigma)\pi$  will increase and, consequently, so will output. Or, in other words: a higher degree of monopoly leads to a lower level of income. Second, as prices tend to increase through the mark-up mechanism, they will become less competitive in international markets, *ceteris paribus*, thus lowering the trade balance  $(X-M)$  also in (4). This is the offsetting effect. This indicates that the overall result on output

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<sup>24</sup> This result follows because in this simple model worker’s savings, government deficit, investment and trade surplus are exogenous. When these variables are endogenized, the inverse relationship between the level of income and the profit share becomes more complicated. In this case, the two variables may be positively related in some circumstances. Bhaduri and Marglin (1990) show that in the Kaleckian framework there is room for a profit-led expansion. Some structuralist authors (e.g. Taylor 1991) claim that developed countries are characterized by profit-led regimes while developing countries would be wage-led.

of a redistribution of income towards workers is ambiguous and depends on which of the two effects dominates.

Note that in the simple model presented above governments can capture foreign profits for domestic oligopolies directly through low wages or depreciated currencies without any need to intervene in the industrial structure to pick up winners. This is quite different from the neoclassical literature based on models of strategic interaction between national oligopolies (e.g. Krugman 1987) where government would need incredible levels of information to choose the actual winners.

The model also explains why low wage strategies are pursued by developing countries that more often than not have a wage-led growth regime. Let's say that there is redistribution towards wages, so that wages go up,  $\tau$  increases less than proportionally and as a result  $\pi$  falls. Then two effects follow. As we already described an increase in  $(1 - \pi)$  implies a higher level of output, since workers have a higher propensity to consume.<sup>25</sup> On the other hand, higher wages and mark ups lead to higher domestic prices, and to reduced competitiveness for the same nominal exchange rate. Hence, the fall in competitiveness leads to trade deficits and lower output (and profits). If the second effect were larger than the first countries would be well advised to maintain trade surpluses.

The model presents coherent reasons for observable policies, which otherwise should dumbfound reasonable people. However, the model does not exhaust the possible explanations for the maintenance of trade surpluses and the accumulation of foreign reserves. Fear of financial market volatility, geopolitical reasons for self-sufficiency, the need to maintain reserves to import essential capital goods, and others are also reasonable explanations.

## 8. CONCLUSIONS

So what do we know about trade and finance? Well hopefully by now it is clear that we know that free trade based on comparative advantage and free mobility of capital to allow the self-adjustment of the balance of payments can only work under very restrictive conditions. The consensus in the 1990s was that those policies were the only ones that were coherent according to economic theory, and, as a result, the only that intelligent people would defend. Only cranks would argue otherwise. However, a long tradition of dissent within the economic profession, and an overwhelming amount of empirical evidence indicated otherwise.

Absolute advantage, determined ultimately by low costs of production and/or depreciated currencies, seems to be far more important than comparative advantage in the determination of trade patterns. Developing countries that pursue 'neo-mercantilist' policies to enhance the competitive position of their firms may in fact be doing something rational, leading to higher rates of growth and higher levels of productivity that would imply higher living standards for their population. Also, the avalanche of financial crises in the 1990s shows that the convictions of post liberalism were unfounded, and that the balance of payments seldom are benign and self-adjusting. Crises are cumulative and the costs of adjustment severe. The Asian Crisis and the more recent one in Argentina make the point very clear. All in all competitiveness does not seem to be a dangerous obsession, on the contrary post liberalism is the real menace.

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<sup>25</sup> Absolute profits go up too then, even though the share of profits in total income fell.

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