WHY WE SHOULD CONCENTRATE ON FREE TRADE AND STOP WORRYING ABOUT THE BALANCE OF PAYMENTS

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> *"More nonsense has been written about the balance of payments than virtually any other aspect of economics."*[1]
>
> *Murray Rothbard*

The modern economics profession's propensity for statistical research makes free trade seem a very complicated, confusing issue. There is surprisingly little interest in the truths first identified by Ricardo.[2] The myths clouding the issues of international trade are largely sustained by misunderstandings about the balance of payments. This article aims to demonstrate first, that free trade is always the best policy for a government to adopt and, secondly, that the balance of payments should not even be measured.

TRADE IS BENEFICIAL

Like trade within national boundaries, trade across international borders benefits both parties. In any exchange buyer and seller both expect to gain. In trade there are no losers; everyone wins.

An individual prevented from trading would have a very low standard of living as they would have to be self-sufficient. They would not be able to specialise and buy the products of others. Rather, they would have to personally produce anything they wanted. International trade extends the division of labour across national boundaries, resulting in even greater specialisation.

THE INTERNATIONAL DIVISION OF LABOUR

There is no difference in the rationale behind the national division of labour and that of the international division of labour. But people get confused by the nonsense surrounding the balance of payments figures. Why else is it acceptable for politicians to speak as if self-sufficiency for the national economy is desirable? They would be correctly identified as lunatics if they suggested London could gain by growing all its own food, or that a remote rural community should produce all its own electrical products. It is obviously undesirable for an individual to have to make everything he wants himself. For the same reasons self-sufficiency is undesirable for a town, province, or nation.

THE LAW OF COMPARATIVE ADVANTAGE

The law of comparative advantage shows why the international division of labour is beneficial to all. It states that every country can improve its welfare by specialising in the most efficient lines of production open to them, those in which they have a comparative advantage. The most efficient lines of production are those in which a country's productivity relative to others is greatest. This is commonly misunderstood to mean those lines of production in which a country is more efficient than all others. If this were true then some countries could conceivably have a comparative advantage in nothing, whereas, in reality every country has a comparative advantage in something, as they must be more efficient in some lines of production than others. For example a very inefficient country in a two-country two-commodity universe may be half as productive as the other country in producing one commodity and only a quarter as productive in the other. Its comparative advantage would lie in producing the commodity in which it had half the productivity of the other country. The law of comparative advantage means that even a country least efficient at producing everything will benefit from free trade. This is because it allows the inefficient country to specialise in what it is relatively poor at producing rather than in what it is *very* poor at producing.

This idea may be clarified by considering the case of an unskilled individual. It is obvious that such an individual benefits from trading in a competitive market economy, because it allows him to specialise in unskilled work. It is more efficient for him to pay for the goods produced by skilled individuals than to attempt to acquire all the necessary skills to produce such goods himself. A brain surgeon, even if he were the best pizza maker there is, would still be likely to have a comparative advantage in brain surgery. Being twice

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as good at pizza making is nothing in comparison to his superiority over most at brain surgery. As his time is necessarily scarce, the brain surgeon benefits from trade with others: it is better for him to specialise in brain surgery and have someone else make his pizza.

THE NATURE OF COMPETITIVENESS

As every factor of production (productive resource) must logically have a comparative advantage in something, it cannot be uncompetitive. Labourers, capital, land, and so on, cannot be said to lack competitiveness, as they will always, by definition, be valuable. It may be, however, that to discover the best way to allocate any given factor of production its price may have to be adjusted. It is important to stress that only *firms*, embodying particular allocations of factors of production, can be said to be uncompetitive. It is always potentially possible for the factors of production themselves to be employed competitively. Therefore, to speak of an uncompetitive firm is to speak of a firm in which the factors of production have been allocated poorly — to where they have no comparative advantage. The factors of production can be reallocated to a project that is competitive.

THE ROLE OF PRICES

Prices are the mechanism by which people and countries can discover where their comparative advantage may lie at any given time. Wage offers and profit levels tell individuals and firms how useful it is for them to be employed in any particular line of production. Barriers to trade artificially increase some profits and wages and reduce the value of others, attracting productive resources into areas where they do not really have a comparative advantage. This reduces the productivity of the economy and, therefore, the welfare of those in it.

Understanding the price mechanism's role is made slightly more difficult by the existence of different currencies. However, if the currency is allowed to float, the price mechanism will still function as explained above. For example, if line of production *A* in Britain becomes uncompetitive because its comparative advantage has been lost, foreign firms in this line of production will sell more goods and acquire more pounds. These foreign firms will then seek to sell the pounds, which will cause the price of pounds to fall (other things being equal). The price of pounds will fall to a level at which other lines of production in Britain have gained enough in competitiveness to compensate for *A*'s decline.

THE EXISTENCE OF NATION-STATES DOES NOT ALTER THE LAWS OF ECONOMICS

Some people seem to have a weird fixation on the "national economy", treating it as the entity to which economic laws apply. The laws of economics are universal. The only sense in which there is a "national economy" is that all individuals in a certain geographical area are victims of the same government.

If people in a particular area really could benefit from being prohibited from buying certain goods from other areas why does the South not call for tariffs on goods from the North of England? Why does Kent not call for tariffs on goods from elsewhere? Why does Dover not close its economy to the rest? How about a single street in Dover? Or a single family? If the protectionists had any case at all surely such policies would need to be considered?

In reality it is a universal truth that barriers to trade can only do harm to an economy. The only firms they preserve are ones whose labour and resources could be more profitably employed elsewhere. They prevent the most efficient division of labour and force consumers to pay more for lower quality.

These economic truths are not trivial. In Britain, because of barriers to trade, we pay more than we should have to for practically every good we buy. This makes our standard of living vastly lower than it would be otherwise. We could also earn far more if we specialised in lines of production in which we have a comparative advantage rather than wasting resources on industries whose survival is due to trade restrictions. Our import restrictions also have a devastating effect on individuals outside Britain, many of whom are far poorer than us. Forcibly preventing someone in the third world from offering their produce to consumers in Britain can, in certain cases, equate to condemning them to death.

WHAT THE BALANCE OF PAYMENTS IS

The balance of payments describes patterns of trade. The current account measures flows of goods and services. The capital account measures flows of funds and financial assets. Trade is recorded in such a way that the balance of payments always balances. For every current account deficit there is a capital account surplus of corresponding size.

Every individual has a balance of payments, as does any group with those external to it. Because of national boundaries, the balance of payments figures are collected for the flows of trade across national borders. There is no logical reason for measuring national balance of payments or, indeed, the balances of any other group or individual.

The balance of payments only describes the structure of trade. It is wrong to evaluate these structures as good or bad, better or worse. All trade is good or would not be agreed to by both parties. If a particular group of individuals has sold assets to buy foreign goods, there is no reason to believe that this is bad. Why would they have done it if that were so?

Any kind of trade flows can be consistent with a high growth or a low growth economy. The shape of the trade flows themselves tells us nothing about whether the economy is successful or not. Contrary to much of the nonsense written about Britain's current account deficit, the U.S. ran a current account deficit for most of the nineteenth century when arguably it had the most dynamic economy the world has ever seen.

THERE IS NO SUCH THING AS A BALANCE OF PAYMENTS CRISIS

A "balance of payments crisis" is nothing of the kind. It refers to the failure of government intervention in the currency market to bring about its political objective, for example, a government selling its foreign currency reserves to buy pounds in order to maintain the price of the pound. If the price of pounds is higher than the market can bear, central bank intervention will eventually fail to prevent a devaluation. Devaluation is simply a price change necessary to match supply and demand for the currency. The "crisis" is, therefore, the mere failure of government intervention to buck the market. The only unsustainable position is that of central bank which has chosen to intervene. As soon as it stops intervening its reserves stop being depleted and the currency moves to the market level. The "crisis" is only a crisis for the central bank and those politicians determining central bank policy.

CURRENT OR CAPITAL ACCOUNT DEFICITS ARE NOT DEBTS

A recurring theme of commentaries on the balance of payments figures is the supposed unsustainability of Britain's current account deficit. The notion of unsustainability is, however, severely flawed. Current account deficits mean that there is a corresponding capital account surplus. They do not have to be paid back. They do not have to be removed at some stage. If a certain group of people wishes to continue trading with another group of people in the same manner, their balance of payments pattern will remain the same.

Borrowing by British citizens from foreign investors is recorded as an increase in the current account deficit and the capital account surplus. But why worry that the British are borrowing more from foreigners than they are borrowing from us? There is no reason to view this as harmful. Any individual who does view borrowing in a bad light can still avoid being a debtor himself. In general we view borrowing and lending as a rational activity on the part of both sides. Why should this change when it happens across borders? And, as numerous governments have demonstrated, so long as income is increasing there is no reason why borrowing cannot continue indefinitely.

ALLOW CONSUMERS TO BUY FROM CHEAP LABOUR COUNTRIES

An argument often heard for tariffs is that domestic firms cannot be expected to compete with cheap foreign labour. This argument is totally fallacious. The reason labour is cheaper in some other countries is because their workers have lower productivity. As these workers increase their productivity the firms they work in may out-compete certain labour intensive domestic industries. But if this happens it will cause their currencies to rise and other industries in those countries to lose competitiveness relative to our domestic industries. A tariff against cheap labour products keeps the foreign workers poor, and prevents domestic consumers buying cheaper products. What is less obvious but equally certain is that it keeps our workers in industries where they no longer have a comparative advantage, and out of industries where they would be productively employed. As stated earlier, factors of production, including labour, cannot be uncompetitive: only the ways in which they are utilised can be, relative to other potential methods of utilisation.

FREE TRADE NOT "FAIR" TRADE

The demand of "fair" trade advocates for a "level playing field" shows their misperception of the nature of trade. It suggests they believe that trade is a zero sum[3] activity rather than the positive sum one it is. It also implies that a foreign government protecting or subsidising its industries is actually unfairly helping its economy. The truth is that trade is mutually beneficial, and remains so regardless of what damage foreign governments inflict on their economies. Why on earth should we start misallocating our resources and denying ourselves the full benefits of specialisation just because the government of another country has done that to its subjects?

IMPORTS ARE GOOD

Imports are often perceived as damaging the domestic economy. In reality they benefit those who buy them and do no harm to the economy as a whole. They also enable foreigners to buy our goods or capital with the pounds spent on their exports to us. Imports are an essential feature of international trade and enable the international division of labour. As such they are extremely beneficial.

DUMPING IS EVEN BETTER

Dumping is the term used by protectionists to describe the phenomenon of very cheap imports. Obviously such imports are even better for consumers of them than imports not viewed as especially cheap. As for producers in the domestic economy, they should produce where they have a comparative advantage, not where they are under cut massively by the foreign competition. As noted earlier, there is no way for imports to reduce the productivity of the domestic economy: they simply encourage specialisation in relatively productive activities.

There is a more sophisticated but equally incorrect argument for protection against dumping. This states that the foreign dumper is attempting to drive the competition out of business so that he can then hike up the prices. If this were the strategy, it could easily be dealt with by a domestic industry. Simply cut production during the dumping period, but maintain capacity for production afterwards. As the foreign producer is selling at a loss during this period, it is clear which producer is more likely to receive financial backing for their strategy. In other words dumping for monopoly status could not work if it were perceived as such by others. And there is no way government can improve the situation when nobody perceives low prices as dumping, as the government would be equally ignorant.

LET DYING INDUSTRIES DIE A NATURAL DEATH

When a large established industry starts to lose its comparative advantage it often uses its political clout to obtain protection from foreign competition. If it is successful, domestic consumers will be denied the benefits of the blocked imports, and the resources in that industry will not be employed in the industries that are increasing their comparative advantage. There will always be such industries as a country's overall competitiveness cannot change. Saving a dying industry keeps the exchange rate higher than it otherwise would be. So if the dying industry is kept alive by government intervention, the gain in comparative advantage by the other industries will never become apparent in the profit figures.

DO NOT SPOIL INFANTS

A favourite argument of modern protectionists is that young and growing (infant) industries are too delicate to be able to compete against established foreign firms. This is yet another fallacious argument. Firms that are not profitable at the moment but likely to be in the future are also likely to have no problem obtaining investment to take them through their development. The only firms unable to do this are those which potential investors believe to be bad risks. For the government to help such firms with protection is to maintain industries that are not believed to have a comparative advantage at the expense of those that do. Government intervention also prevents any further assessment of whether the industry does represent a valid allocation of resources. How can investors know if profits are due solely to tariffs or not? The only way to find out is to allow free trade.

DO NOT PREVENT INVESTMENT ABROAD

There is much hostility towards domestic capitalists who invest overseas. They are often mistakenly viewed as betraying the domestic economy. In reality this investment benefits the individuals carrying it out and in no way harms the domestic economy. An increase in investment abroad reduces the price of the currency. This makes domestic goods more price-competitive up to the point where the increase in investment abroad is fully matched by the resultant increase in exports and reduction in imports. Preventing investment abroad means that domestic capitalists receive lower returns on their capital and domestic production is less profitable than would otherwise be the case.

ALLOW FOREIGN INVESTMENT

To the credit of the protectionists they are at least consistent. They consistently oppose international trade of whatever kind. Not only is investment abroad condemned — so is foreign investment in the domestic economy. They appear believe that investment abroad benefits foreigners and harms us and that foreign investment here does the same. Presumably not only is trade supposed to be zero sum, but we are always on the losing side.

Foreign investment makes possible economic ventures that are economically viable but that otherwise would not occur. This helps consumers, potential workers in those industries, and the potential foreign investors.

UNILATERAL FREE TRADE AND AN END TO THE BALANCE OF PAYMENTS

Whatever other countries do by way of trade restrictions the best policy is always free trade with everyone. Trade is always beneficial to both sides. Trade barriers are always harmful to both sides.

The statistics are not to blame for the appalling errors and misleading statements of those interpreting them. However, there is no valid purpose in measuring and categorising the flows of trade across an arbitrary national boundary. Just let the exchange rate float, stop the central bank meddling, and sack the statisticians along with the rest of the customs staff. This way the economics profession would have to stop playing with at least one set of worthless statistics. Who knows, if they started considering the fundamental facts again, they might rediscover the value of free trade and the international division of labour.

> *"Worries about national balances of payment are the fallacious residue of the accident that statistics of exchange are far more available across national boundaries than elsewhere."* [4]
>
> *Murray Rothbard*

NOTES

1. Murray Rothbard, *Man, Economy and State*, Nash Publishing, Lost Angeles, 1962.
2. Ricardo is the classical economist credited with being the first to develop the law of comparative advantage, which shows that international trade benefits all participarticipants.
3. Zero sum refers to the results of change. If trade were zero sum there could be no mutual gain: if someone gained, another must lose.
4. Rothbard, *Man, Economy and State*, p. 722.