consequences of the introduction of such a tax. We would, though, anticipate that the most substantial obstacles associated with the introduction of a transactions tax are those emanating from the political realities. Two such obstacles stand out, namely the required international coordination and the political power of the financial sector.

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# 14. Say's Law in the open economy: Keynes's rejection of the theory of comparative advantage

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## I INTRODUCTION

While much ink has been spilled over the question of Keynes's trade *policy* views, very little has been said about his explicit or implicit *theory* of international trade.[2] But – as Keynes himself stressed – all policy positions reflect an underlying theory, and Keynes's views on trade theory were perhaps more controversial even than his political stance of 'pragmatic protectionist'. As he developed his theory of the monetary production economy that would form the framework for the *General Theory*, Keynes came to reject the idea of comparative advantage as the determinant of the direction of trade. His position was contrary to the views of both Marshall (1879, 1923), his former teacher and expert in trade theory, and Eli Heckscher, whose 1919 article has been credited with first stating the factor endowments theory. The principle of comparative advantage assumes full (or at least constant) employment and a price adjustment mechanism sufficient to convert comparative cost differences into absolute money cost differences and bring balanced trade. Keynes rejected the assumption of such an automatic adjustment mechanism, arguing instead that interest rates – not prices – do the adjusting, and that a persistent trade imbalance – not balanced trade – is the likely outcome. For Keynes, the balanced trade implication of comparative advantage theory is equivalent to Say's Law in an open economy context, whereby an addition to export supply automatically creates an import of equivalent value, or vice versa. Persistently unbalanced trade has important policy implications, since it leads to interest rate pressures that will move the economy further away from full employment.

In section II I discuss Keynes's own theory of international trade, and in section III I argue that one of the reasons for placing the *General Theory* in a closed economy framework was Keynes's belief that the argument for the theory of effective demand would have been weaker, that is less general, if it had allowed for the possibility of persistent current account imbalances. Section IV briefly discusses the dissimilarity between Keynes's and Marshall's views on trade and the similarity, surprisingly, of Keynes's view to those of Marx. Section V concludes with a comment on the present-day relevance of Keynes's heretical trade theory perspective.

## II COMPARATIVE ADVANTAGE AS A SPECIAL CASE

Keynes's international trade policy prescriptions changed over time. In the early 1920s, he supported free trade on the grounds that comparative advantage led to optimal specialization and that 'an artificial interference with imports must either interfere with exports or involve an artificial stimulation to capital to leave the country' (CW XIX: 148) (see Wolf and Smook, 1988:174). By 1930, however, Keynes had changed his views and considered the potential costs of a tariff as outweighed by the benefits. The change in views was in part a response to the change in economic conditions faced by Britain and in part a reflection of the evolution of his theoretical views. In an economy with a high level of unemployment, Keynes argued, the case for free trade is no longer valid. In the Macmillan Report of 1930, he wrote:

> The fundamental ground of the free trade argument is that we ought to take the McKenna Duties off in order that we should stop the making of cars and make something else for which we are better suited. And the logical link between one and the other is through this chain, and no other. Just like the Bank rate argument, it works beautifully in a fluid system. But supposing we get jammed at the point of unemployment, the alternative for a time may be between producing motor cars or producing nothing. (CW XX: 114)

This policy view has a clear theoretical underpinning, and in particular one can see an implicit rejection of the law of comparative advantage. According to the theory of comparative advantage it is not possible for a nation to 'produce nothing' for export. The importance of relative, not absolute, costs and prices means that by definition a nation always has a comparative advantage in, and can export, something. For the Keynes of the 1930s it was absurd to spin theories based on the assumption of full employment. Since the model supporting the free trade argument was traditionally based on such an assumption, Keynes insisted on the irrelevance of both the policy and, implicitly, the underlying theory. Again in the Macmillan Committee Report of 1930, Keynes wrote:



> The fundamental argument for unrestricted free trade does not apply without qualification to an economic system which is neither in equilibrium [that is, at full employment] nor in sight of equilibrium. For if a country's productive resources are normally fully employed, a tariff cannot increase output, but can only divert production from one direction into another, whilst there is a general presumption that the natural direction for the employment of resources, which they can reach on their merits and without being given special advantages at the expense of others, will yield a superior national dividend. But if this condition of full employment is neither fulfilled nor likely to be fulfilled for some time, then the position is totally different, since a tariff may bring about a net increase of production and not merely a diversion. (CW XX, 298)

Under conditions of persistent unemployment the theory of comparative advantage is irrelevant because the mechanisms which would otherwise transform a situation of differential comparative costs into one of differences in absolute money costs and prices no longer operate. That is, the adjustment simply does not take place to a sufficient degree to guarantee that the 'law' of comparative advantage will dictate the commodity composition and the balance of trade. Moreover, the normative dictates of the doctrine may also fail to hold, since it assumes full employment. The free trade argument against a tariff, Keynes pointed out in 1932, assumes that the additional workers employed in the protected industry 'will be employed in some other more suitable industry, and does not allow for the contingency that they may not be employed at all' (CW XXI: 207–8).

Keynes rejected the likelihood and efficiency of each of the 'classical' adjustment mechanisms – wages, exchange rates – when persistent unemployment characterizes the economy. Regarding wage adjustment, Keynes did not deny it as a logical possibility, but was sceptical as to both its likelihood and its advisability. In July of 1930, he wrote to Prime Minister Macdonald:

> Free trade is profoundly based on the assumption of equilibrium conditions and in particular that wages always fall to their strict economic level. If they do not, and if for several reasons we do not desire them to, then it is only by means of a tariff that the ideal distribution of resources between different uses, which free trade aims at, can be achieved; and there is an unanswerable theoretical case for a countervailing import duty (and also for an export bounty) equivalent to the difference between the actual wage and the economic wage . . .
>
> I am no longer a free trader – and I believe that practically no-one else is – in the old sense of the term to the extent of believing in a very high degree of national specialisation and in abandoning any industry which is unable for the time being to hold its own. Where wages are immobile, this would be an extraordinarily dangerous doctrine to follow. (CW XX: 379–80)

Keynes admitted that reductions in the money wage would have a positive effect on the current account. But he denied the automaticity of such an adjustment and warned of its negative effects due to its overall contractionary nature and its regressive distributional consequences. A drastic reduction in money wages would lead to 'social injustice and violent resistance since it would greatly benefit some classes of income at the expense of others' (CW IX: 235–6).

Keynes also viewed devaluation as out of the question because of its contractionary implications, and because it reflected the misplaced notion that the deficit country should bear the entire burden of adjustment (Wolf and Smook, 1988; Davidson, 1992–3).[3] It is not certain that Keynes would have denied the likelihood of automatic adjustment under a flexible exchange rate system. But given that there is little doubt that the flexible exchange rates in the post-Bretton Woods era have not served the purpose of automatic adjustment, it is hard to imagine Keynes arguing for its efficiency. The exchange rate has been driven by financial considerations, and certainly has not responded to 'fundamentals' like the balance of trade (Harcourt, 1995b; Harvey, 1995; Akyüz, 1994; Blecker, 1991; Krugman, 1988).

For Keynes, trade imbalance leads not to a change in the price level (or to an automatic adjustment of wages or exchange rates) but to a potential liquidity problem for the deficit country. A change in the trade balance will result in a change in the monetary base. This will lead to a change in the rate of interest. Thus an improvement to surplus on current account will not bring a rise in wages, but a lowering of interest rates. (See Radice, 1988: 158; Wolf and Smook, 1988: 174). In fact, Keynes argued, under certain conditions the balance of payments is the main determinant of the rate of interest. In this case, efforts to improve the balance of trade are crucial to the achievement of full employment (Keynes, CW VII: 348).

The trade surplus country accrues liquid assets: there is no reason to assume these will be converted into non-liquid assets, much less into foreign-produced non-liquid assets. Saving is thus the mechanism which creates the possibility of both underemployment equilibrium and persistently unbalanced trade. For Keynes, the law of comparative advantage is the international analogue of Say's Law. Just as money-wage flexibility is insufficient to bring about full employment in the closed economy of the *General Theory*, so will money-wage flexibility fail to bring about balanced trade in the open economy context. To the extent that the normative side of the law of comparative advantage relies on the assumption of full employment, it will be invalid since the economy has no natural tendency towards such a condition. The desire for liquidity, to hold money owing to uncertainty, is inherent to the functioning of a monetary production economy. Without liquidity needs there would be no need for money, and the system would in fact be the barter system which characterizes the 'pure theory' of international trade (Davidson and Kregel, 1980: 147).



The logic of comparative advantage implies continually balanced trade. Trade imbalances can only be transitory. This amounts to the assertion that imports and exports are causally related: that is, a decrease in imports should lead to an equivalent decline in exports. This was the argument put forth by Robbins and Beveridge in their rejection of Keynes's call for a revenue tariff to create employment: a reduction in imports will be met with an equal reduction in exports because it will mean, according to Beveridge, 'a reduction of the power of foreigners to buy in Britain' (CW XX: 508). Keynes attacked the Robbins/Beveridge view as true only

> in a hypothetical economic system possessing such an inherent capacity for stable equilibrium, that not only were both the initial and the final positions in equilibrium, but the elasticity of the system was such that any disturbance was responded to so immediately that the system was incapable of ever departing appreciably from equilibrium. (CW XX: 503)[4]

Keynes argued that an import reduction would allow the central bank to lower interest rates, depending on international capital mobility, and the import responsiveness in the rest of world to interest rate and investment changes. The result could be either an increase or a decrease in exports. The comparative advantage view that trade automatically tends to an equality of imports and exports, echoed in many current arguments for free trade, was, according to Keynes, 'due to a complete misunderstanding of the theory of equilibrium in international trade' (CW XX: 509).

Keynes's implicit refutation of the law of comparative advantage can be seen as analogous to his rejection of 'classical' macroeconomics in the first chapter of the *General Theory*. Each is a special case of a larger set of possibilities. Full employment is a possible (although unlikely) outcome, depending on Say's Law. Similarly, the transformation of international comparative cost differentials into absolute money cost and price differentials is a possible, but again unlikely, outcome.

## III OPEN ECONOMY FOUNDATIONS FOR THE *GENERAL THEORY*?

While Keynes's ideas on the theory of international trade are typically viewed as subordinate to his views on effective demand and unemployment equilibrium, it is arguable that the key ideas of the *General Theory* were in part spurred by his thinking about international trade problems. It is significant that Keynes's views on commercial policy beginning in 1930 were considered quite radical. Joan Robinson noted the radical departure from the orthodoxy that Keynes's position on tariffs in 1930 (the 'revenue tariff') represented: 'In some way the unkindest cut of all [against laissez-faire] was Keynes's repudiation of the doctrine that tariffs must be harmful to the country that imposes them' (Robinson, 1962: 86). Moreover, the 'revenue tariff' proposal of 1930 was considered by many to be heretical, a radical departure from Keynes's earlier views. Harrod (1951: 424) called the advocacy of tariffs 'momentous, a betrayal of free trade'. Beveridge, in an indignant letter of response to Keynes published in *The Times*, wrote:

> The test of economic progress is not the maximising of employment, but the maximising of wealth in relation to effort; that, according to the nearly universal opinion of all economists since Adam Smith, means the use of the natural resources of each country in the ways determined by experience under free conditions to be most economical and not their use as distorted by tariffs. Does Mr. Keynes differ from this? (CW XX: 510)

Thus, while Keynes's ideas on the theory of international trade are typically viewed as subordinate to his views on effective demand and unemployment equilibrium, it is arguable that the key ideas of the *General Theory* originated with Keynes's thinking about international trade problems. For example, in the Macmillan Committee Report, Keynes wrote:

> We know no way in which the initial impetus to increased employment can be given except by (i) an increase of exports, (ii) the substitution of home-produced for goods now imported, or (iii) an increase of investment at home . . .
> *Indeed the whole problem may be made to centre around the balance of trade.* (CW XX: 285–6, emphasis added)

The solution of the revenue tariff was rooted in the recognition of unemployment equilibrium. If unemployment were only temporary then free trade would be optimal and balanced trade would result from the workings of comparative advantage. But precisely because of the persistence of unemployment, Keynes rejected the free trade prescription, ruling out devaluation and money-wage cuts in order to achieve balanced trade. It was in part the impossibility of free trade bringing full employment which pushed Keynes to formulate a general theory of the existence of unemployment equilibrium. Much of his writing from 1929 to 1933 dealt with the issue of free trade and protectionism and the argument that under conditions of less than full employment a policy of free trade could actually worsen economic conditions (the 'contractionist cure'). That the issue of tariffs hardly figures at all in the *General Theory* (except Chapters 23 and 24) is an indication that Keynes sought to work out the problem of persistent unemployment equilibrium in a closed economy context.[5] This does not rule out the possibility that consideration of an unemployment



equilibrium may have arisen with the thinking on tariff policy and laissez-faire. The idea of an unemployment equilibrium was perhaps so obvious to Keynes in an open economy framework that he sought to show its general applicability by proving the possibility of its existence in conditions not affected by unbalanced international transactions. Thus the *General Theory* may have been placed in the context of a closed economy for the same reasons that Keynes is said to have avoided non-neoclassical conceptions of market structure, pricing or scale economies: if proved only in the presence of such 'distortions', the result of unemployment equilibrium would be discounted for having relied crucially upon these assumptions.

The links between Keynes's views on international trade and the insights of the *General Theory* go beyond analogy. Keynes's transformation on the subject of trade policy was both a response to changing economic conditions *and* a reflection of the development of his theoretical views. In the *General Theory*, Keynes strongly endorsed the view that, in a situation of less than full employment, comparative advantage is inoperative. In Chapter 2, Keynes includes 'the unqualified advantages of laissez-faire in respect of foreign trade' among a list of widely-held views which are thrown into doubt once the saving–investment nexus is broken. In Chapter 23, on mercantilism, Keynes quotes with praise an 1899 statement of the view that the argument for free trade is 'based on the assumption that over-supply is impossible' (Keynes, CW VII: 368). But there are clear indications well before 1936 that Keynes understood the theoretical implications of his policy views. In 1930, even prior to his debate with Beveridge, Keynes wrote:

> To suppose that there exists some smoothly functioning automatic mechanism of adjustment which preserves equilibrium if only we trust to methods of laissez-faire is a doctrinaire delusion which disregards the lessons of historical experience without having behind it the support of sound theory. (CW XXV: 21–2)

By analysing the underlying theoretical stance which informed the policy conclusions on tariffs instead of focusing on the policy prescriptions themselves, one sees that Keynes's rejection of the free trade doctrine was closely linked to his development of an unemployment equilibrium for which the *General Theory* is best known. This view is counter to the claims of Eichengreen (1984) and Pressman (1992) that Keynes's trade policy perspective remained the same and was altered only in response to changing economic conditions. Surely, between the mid-1920s and the mid-1930s, both economic conditions and Keynes's theoretical perspective changed drastically (Radice, 1988: 160).

## IV RICARDO, MARX, MARSHALL, KEYNES

Comparative advantage has been embraced by economists perhaps longer than any other concept in the history of economic thought. While the precise origins of the concept have been the subject of some debate, the treatment by Ricardo in *The Principles* is generally accepted as the landmark statement.[6] While all economists are familiar with the principle, it is worth reviewing it with an eye on its implied price adjustment mechanism – the mechanism that would be the focus of Keynes's attack on the free trade argument.

From the perspective of global output, Ricardo argued the logic of specialization according to comparative advantage:

> Two men can both make shoes and hats, and one is superior to the other in both employments; but in making hats, he can only exceed his competitor by one-fifth or 20 per cent., and in making shoes he can excel him by one-third or 33 per cent.; – will it not be for the interest of both, that the superior man should employ himself exclusively in making shoes, and the inferior man in making hats? (Ricardo, 1951: 136)

But the principle also had to make sense as a market phenomenon. That is, no consumer in any country could be expected to purchase a foreign good at a higher price than the going domestic price. Thus when one country has an absolute productivity (or, more generally, cost) advantage or disadvantage in all sectors, the principle of comparative advantage will determine specialization and trade patterns only if comparative cost differentials automatically become absolute money cost and price differentials.

Consider Ricardo's (1951: ch. 7) well-known example of labour-hours per unit of output of wine and cloth in Portugal and England:

| | *Wine* | *Cloth* |
|---|---|---|
| Portugal | 90 | 80 |
| England | 120 | 100 |

The existence of an absolute disadvantage in the production of all commodities for England will lead to a temporary trade deficit for England and a surplus for Portugal. This disequilibrium will invoke Hume's price–specie–flow mechanism, whereby the trade imbalance brings a flow of gold from the deficit to the surplus country. The result will cause the price level to rise in Portugal (the surplus country) and to fall in the deficit country. This price level movement continues until one commodity becomes cheaper in England. This will be the commodity which is produced with the smallest absolute disadvantage, that is, for which England



has a comparative advantage. Once England is competitive in at least one commodity, it will specialize in and export that commodity up to the point where trade is balanced.

By assuming the smooth functioning of the Humean adjustment mechanism, trade theorists since Ricardo have been able to maintain the notion of international trade as a barter relation. For example, John Stuart Mill (1909: 583) wrote, 'since all trade is in reality barter, money being a mere instrument for exchanging things against one another . . . international trade . . . [is] in form, what it always is in reality, an actual trucking of one commodity against another'. And Angell, whose 1926 book was quite influential, wrote, 'Price readjustments, for example, are apparently regarded as fundamentally frictionless, and money is at bottom treated as a merely passive transmitter of inter-commodity values (Angell, 1926: 84–5). Alfred Marshall did not question this aspect of trade theory as 'pure' (non-monetary) theory. His contribution was to provide a rigorous geometric treatment of Mill's reciprocal demand model of trade, introducing a simple representation of the elasticity of import demand and export supply that would allow a more sophisticated understanding of the determination of the barter terms of trade. While it is likely that Marshall's presentation in his 1923 book was the 'state of the art' when Keynes was writing the *General Theory* – Ohlin's pathbreaking work on the role of factor endowments was not published in English until 1933 – Marshall's model is entirely a barter model. That is, exports are 'expenditures on imports', and thus trade is in balance by definition (see Allen, 1965: 15).

Keynes was of course a student of Marshall, and the Marshallian influences on Keynes's thought have received considerable attention (see Jensen, 1983). At the same time, Keynes's predilection for, and even familiarity with, Marxian economic thought was minimal. It is curious then, that, Keynes's views on international trade theory are closer to those of Marx than of Marshall.

According to Shaikh (1980: 208), 'Marx himself never directly accepts or rejects Ricardo's principle of comparative costs.' But a Marxian critique of comparative advantage can be found in Marx's rejection of the requirements of its implied automatic adjustment mechanism, that is, of the mechanism which converts differential comparative cost ratios into differences in absolute money cost or price differences. There are two parts to the Marxian critique. First, Marx calls into question the functioning of the price–specie–flow mechanism. He argues that a 'temporary' disequilibrium trade imbalance will lead the deficit country to experience a fall in bank reserves, not an outflow of gold, as predicted under the price–specie–flow mechanism. The result of this decline in reserves is an increase in the interest rate. According to Marx:

> It is indeed an old humbug that changes in the existing quantity of gold in a particular country must raise or lower commodity prices within this country by increasing or decreasing the quantity of the medium of circulation . . .
> In fact, a decrease in the quantity of gold raises only the interest rate, whereas an increase in the quantity of gold lowers the interest rate; and if not for the fact that the fluctuations in the interest rate enter into the determination of cost-prices, or in the determination of demand and supply, commodity-prices would be wholly unaffected by them. (Marx, 1967, vol. 3: 551)

Thus Marx's view of the adjustment mechanism was similar to that which Keynes would propose some fifty years later. Since both economists emphasized the likelihood of persistent unemployment, they focused on the relation between money inflows and outflows and interest rates rather than wage and exchange rate responses to relative price adjustments. Relative price changes induced by moving from autarky to free trade would be expected to bring only limited adjustment in the presence of persistent excess capacity (Kregel, 1980: 267–8). And both Keynes and Marx rejected the notion that the rate of interest is a reward for saving or abstinence.

The similarities in the Keynes and Marx critique of the comparative advantage model extends also to questions of money and scarcity. Ricardo's reliance on the quantity theory was, according to Marx, based merely on assertion. Marx argued that Ricardo should instead prove the validity of this mechanism (Visser, 1977: 281). Thus, instead of the price level adjusting to render comparative advantage operational, the interest rate adjusts, and specialization fails to occur. But will not the interest rate change bring, indirectly, a change in the price level? This is where Marx's second criticism of the law of comparative advantage comes into play. The interest rate increase generates a decline in investment demand which puts downward pressure on prices. But this temporary downward movement in prices brings a reduction in supply which raises prices back to their original level. Ultimately, no change in the price level occurs because of the persistence of excess capacity and unemployment.[7] Ricardo's (1951: 128) assertion that 'no extension of free trade will immediately increase the amount of value in a country' is tantamount to the view that no capacity expansion can occur in the move from autarky to free trade (Dosi *et al.*, 1990: 26). Marx criticized Ricardo directly for his assumption of full capacity utilization:

> It is futile to speak of the stimulus given by Australian gold or a newly discovered market. If it were not in the nature of capital to be never completely occupied, i.e. always partially *fixated*, devalued, unproductive, then no stimuli could drive it to greater production. At the same time, [note] the senseless contradictions into which the economists stray – even Ricardo – when they presuppose that capital is always fully occupied; hence explain an increase of production by referring exclusively to the creation of new capital. Every increase would then presuppose an earlier increase or growth of the productive forces. (Marx, 1973: 623)



Marx thus rejected Ricardo's assertion that trade creates no value, asserting that 'whatever is true of foreign trade is also true of home trade' (Marx, 1967, vol. 3: 324).

For Marx the capitalist economy is inherently monetary. The reduction of such an economy into 'money' and 'real' components is analytically unacceptable, and based on 'a simple abstraction of their points of difference' (Marx, 1967, vol. 1: 128). Money is the logical and necessary outcome of a system of commodity production and thus money can never be a veil. The barter economy is a conception useless in the analysis of capitalism (Visser, 1977: 282–3): 'The circulation of money as capital is . . . an end in itself . . . It is only in so far as the appropriation of ever more and more wealth in the abstract [money] becomes the motive of his operation, that he functions as a capitalist' (Marx, 1967, vol. 1: 169–70).

For Marx the law of comparative advantage is invalid because the automatic adjustment mechanism it requires is rooted in a faulty theory of money. Moreover, because of the permanence of unemployment in the form of the reserve army of the unemployed, the welfare effects of international trade resulting from specialization would be negligible, and ultimately negative.

Marx supported free trade, based on the cynical claim that free trade would raise the level of class conflict:

> in general, the protective system of our day is conservative, while the free trade system is destructive. It breaks up old nationalities and pushes the antagonism of the proletariat and the bourgeoisie to the extreme point. In a word, the free trade system hastens the social revolution. It is in this revolutionary sense alone, gentlemen, that I vote in favour of free trade. (Marx, 1982: 224)

Note that this argument refers neither to wage adjustment nor to capital flows. For Ricardo, wage changes are not able to bring about rising competitiveness, since a lower wage is, by definition, met by a rise in the profit rate. Marx agrees with Ricardo on this point:

> The English workers have very well understood the significance of the struggle between the landlords and the industrial capitalists. They know very well that the price of bread was to be reduced in order to reduce wages and that industrial profits would rise by as much as rent fell. (Marx, 1982: 213)

Repeal of the corn laws would lower the price of corn and thus raise the real wage if nominal wages are constant. But of course nominal wages are not constant:

> When less expense is required to set in motion the machine which produces commodities, the things necessary for the maintenance of this machine, called a worker, will also cost less. If all commodities are cheaper, labour, which is a commodity too, will also fall in price. (Marx, 1982: 215)

To the extent that free trade 'increases productive force, competition among workers grows in a far greater proportion' and thus wages actually decline.[8] The move to free trade brings an accumulation and concentration of capital, whereby large industrialists enjoy the fruits of scale economies and small industrialists get driven out of business and into the proletariat, putting downward pressure on wages. Moreover, 'the progress of industry creates less expensive means of production. Thus spirits have taken the place of beer, cotton of wool and linen, and potatoes that of bread' (Marx, 1982: 221). Nominal wages fall accordingly. In the adjustment from protection to free trade, only some of the newly unemployed workers are able to move to jobs in other sectors.

There are two features of the Marx/Keynes critique of the concept of comparative advantage. First, because of their insistence on the inherently monetary nature of capitalist economies, Marx and Keynes could be said to have considered the notion of a 'pure' theory of trade, as opposed to a monetary-based theory, irrelevant for the study of international exchange in a capitalist society. Both economists rejected the classical dichotomy between a 'real' and a 'monetary' side of the economy, each lending itself to a separate sphere of analysis. Pure trade theory requires such a dichotomy. For both Marx and Keynes the monetary system functions in such a way that no automatic adjustment mechanism converts a situation of comparative cost differentials into one of absolute money cost and price differences. Adjustment is through interest rates. Second, for both economists capitalism is characterized by persistent unemployment and excess capacity, albeit for different reasons.[9] There is no tendency for the price system to generate full employment.

Underpinning these common features of the rejection of comparative advantage in Marx and Keynes is the denial of resource scarcity as the driving force of economic phenomena.[10]

The implications of the rejection of scarcity for the treatment of international trade are threefold. First, it requires the reconsideration of the positive theory of international trade based on adjustment strictly due to relative price changes. Second, it introduces the drive for capital accumulation and growth as essential to the process of international exchange (Shapiro, 1977). Third, it raises the possibility that international competitiveness is created, not endowed. The determination of the direction of trade can be rooted outside the realm of natural factor endowments.



Keynes certainly understood this in his appeals to protect aspects of British industry, on the grounds that such sectors were growth-generating and needed temporary protection to weather the slump. Marx, too, understood the political economy of international specialization:

> For instance, we are told that free trade would create an international division of labour, and thereby give to each country the production which is most in harmony with its natural advantages. You believe, perhaps, gentleman, that the production of coffee and sugar is the natural destiny of the West Indies? Two centuries ago, nature, which does not trouble herself about commerce, had planted neither sugar-cane nor coffee trees there. (Marx, 1982: 223)

## V BALANCED TRADE: A 'PUERILE OBSESSION' FOR THE 1990s

Keynes's (and Marx's) rejection of the theory of comparative advantage creates the space – and in fact the necessity – for a discussion of international competitiveness, that is an analysis of just how firms and nations successfully capture world export market shares. This has of course been a topic of considerable debate in the advanced capitalist countries in the 1980s and 1990s. The severe deterioration of the US current account in the 1980s led many non-economists to call for measures to enhance 'international competitiveness'. Paul Krugman (1994a) characterized the concern with international competitiveness as a 'dangerous obsession'. Krugman's views on competitiveness are driven by his assertion of the primacy of the principle of comparative advantage:

> International competition does not put countries out of business. There are strong equilibrating forces that normally ensure that any country remains able to sell a range of goods in world markets, and to balance its trade on average over the long run, even if its productivity, technology, and product quality are inferior to those of other nations . . .
>
> Both in theory and in practice, countries with lagging productivity are still able to balance their international trade, because what drives trade is comparative rather than absolute advantage. (Krugman, 1991: 811, 814)

Krugman's response to those unwilling to accept the relevance of the logic of the principle of comparative advantage has been to try to ridicule them:

> I have tried carefully explaining economic concepts like, say, comparative advantage; it doesn't work. What does work, sometimes, is ridicule. If you can make someone who imagines himself to be a deep sophisticate look silly, sometimes it gives him – or at least someone else who might be tempted to follow the same route – pause. (Krugman, 1996: 10)

Keynes in fact criticized economists of his day precisely for such arrogance and condescension towards those policy makers concerned with trade deficits. Keynes (1936: 339) wrote:

> the weight of my criticism is directed against the inadequacy of the theoretical foundations of the laissez-faire doctrine upon which I was brought up and which for many years I taught; – against the notion that the rate of interest and the level of investment are self-adjusting at the optimum level, so that preoccupation with the balance of trade is a waste of time. For we, the faculty of economists, prove to have been guilty of presumptuous error in treating as a puerile obsession what for centuries has been a prime object of practical statecraft.

Since the late 1970s, when the 'golden age' of capitalism gave way to the era of 'globalization', there has been a slowdown of world economic growth, an explosion in the volume of international capital flows, persistently high unemployment in industrialized countries and chronic excess capacity in many manufacturing industries across the globe. Trade imbalances are larger and more persistent than before, and exchange rates are increasingly delinked from economic fundamentals such as the trade balance. The conditions under which comparative advantage might be operative are thus less present today than they were twenty years ago (Milberg, 1996). Certainly, a theory whose central notion is the stability of a balanced trade equilibrium should be presented cautiously and modestly in today's world. If international competitiveness is a 'dangerous obsession', the assumption of balanced trade is a 'puerile obsession'.

As in so many other areas of economic thought, Keynes's insights into the functioning of international trade have been ignored or misinterpreted by the mainstream. Keynes's critique of the principle of comparative advantage indicates that international trade economists would be well served to show some modesty about the practical applicability of their theories.

## NOTES

1. I am grateful to Robert Blecker, Arthur Bloomfield, Paul Davidson, Bruce Elmslie, Geoff Harcourt, Jan Kregel and participants in the second conference on Keynes, Knowledge and Uncertainty, held at the University of Leeds, March 1996, for comments on an earlier draft. I alone am responsible for remaining errors and misinterpretations.
2. On the evolution of Keynes's trade policy position, see Eichengreen (1984), Wolf and Smook (1988), Radice (1988) and Pressman (1992). Best known of Keynes's writings on this issue is his July 1933 essay, 'National Self-Sufficiency'. In terms of Keynes's international trade theory views, however, a number of earlier essays are more important.
3. Keynes's view that the effect of a devaluation or tariff depends on 'whether the initial position was one of equilibrium' (CW XX: 504) is captured formally by Krugman and Taylor (1978, case 2).



4. Beveridge and several other prominent economists (including Robbins and Hicks) published their free-trade response to Keynes's tariff proposal in a 1931 book, *Tariffs: The Case Examined.*
5. This could also be viewed as the world economy, which is by definition closed and thus without trade imbalances since it is without 'foreign' trade.
6. For a fascinating discussion of the earlier statement of the doctrine by Torrens and the influence of James Mill on Ricardo himself, see Thweatt (1976).
7. See Shaikh (1980). In more recent work, Shaikh (1992) has developed a Marxian model of exchange rate adjustment, in which trade imbalances can persist in spite of exchange rate movements.
8. Moreover, for Marx wage changes are irrelevant when direct prices are being considered (Shaikh, 1980).
9. According to Dillard (1984), 'Marx's industrial reserve army resembles Keynes's involuntary unemployment, with an important difference. Keynes's involuntary unemployment arises from a deficiency of effective demand and could be alleviated by an increase in investment, whereas the members of Marx's industrial reserve army are the victims primarily of technological unemployment associated with investment.'
10. Shapiro (1977) locates 'the revolutionary character of Post Keynesian economics' in its rejection of scarcity. Matthei (1984) discusses the importance of the Marxian rejection of this fundamental neoclassical concept.