BARNETT HOUSE PAPERS
No. 15

BALANCE OF TRADE DELUSIONS

BY
EDWIN CANNAN
Emeritus Professor of Political Economy in the University of London

SIDNEY BALL LECTURE
November 13, 1931

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BALANCE OF TRADE DELUSIONS

THIS lecture is going to be a very elementary one. I do not think the founders of the Sidney Ball Lecture intended it for the kind of discussion of which we see examples in the *Economic Journal* when the inmost circle of experts dispute about imaginary phenomena with all the fervour of Roman augurs interpreting the meaning of the entrails of a sacrificed goose. But I would not have ventured on so elementary a subject as balance of trade delusions three months ago. It is the immense volume of silly talk about the balance of trade which has emerged from the highest quarters both of the political and the business world which has convinced me that we economists have hitherto completely failed in our duty to make this matter clear to the public. So completely have we failed in the two hundred years since we began to exist as a class, that if David Hume were still alive he could repeat to-day with perfect truth what he said in 1752—'This apprehension of the wrong balance of trade . . . discovers itself wherever one is out of humour with the ministry or in low spirits', and he could add, as he added then, that if the Heptarchy was still in existence in England, the legislature of each of the seven states would have been continually in fear of a wrong balance and would have loaded and oppressed all its commerce with the others 'by a jealous and superfluous caution'.

The guise in which the bogy of a 'wrong', 'unfavourable', or 'adverse' balance of trade appears has indeed changed somewhat since Hume's time, but the bogy itself remains as unsubstantial as ever.

The balance of trade theory began to be taught about the beginning of the seventeenth century or a little earlier, and underwent no appreciable modification for at least a hundred and fifty years. Postlethwayt's *Dictionary*, in 1755, says 'that which is commonly meant by the balance of trade is the equal importing of foreign commodities with the exporting of the native', i.e. trade balances exactly when the imports and exports of commodities are exactly equal. But the term 'commodities', though it might be explained as including services, did not include money and the two precious metals of which money used to be made, gold and silver. It was taken for granted and accepted by all that imports and exports *including* gold and silver must be equal, and if that is so, it is obvious that if the imports and exports of commodities and services other than gold and silver don't balance, 'the balance' as it is called, i.e. the amount necessary to make the two sides of the account equal, must be made up by a net import or export of gold and silver. Then, as the acquisition of gold and silver was supposed to be the great end of trade, the 'balance' was said to be 'favourable' when it showed a net import of precious metals, and 'unfavourable' or 'wrong', to use Hume's phrase, when it showed a net export of those metals.

Postlethwayt makes this quite clear. After saying that trade balances when imports and exports are equal in value, he goes on to explain that a nation is reckoned to have the advantage in the balance of trade when it exports a greater value than it imports, and that 'the reason of this is' that if the exports exceed the imports, the balance 'must be made up in bullion or money' and the nation consequently 'grows richer' by that amount. This being the Balance of Trade Theory as understood from its birth about the beginning of the seventeenth century to the middle of the eighteenth, what were then the balance of trade delusions? There was little need in that period for any one to quarrel very much with the basic assumption that when proper allowance is made for transport expenses, imports and exports *including* gold and silver must be equal in value. There were indeed already some economic transactions between different countries which were not purchases and sales of merchandise; tributes and gifts were not unknown. But what Thomas Mun said in 1630 remained true, that these things were 'uncertain and of small consideration'. Later they become of paramount importance, as we shall see presently.

If we accept that main assumption, not as absolutely correct, but as a tolerable approximation to the facts of the time, we can say there were during that period two balance of trade delusions, firstly, the belief which Adam Smith ridiculed, that a perpetual and indefinitely large net inflow of gold and silver was a thing to be desired by each country, and, secondly, the belief which Hume scoffed at, that the way to get a sufficient inflow into a country, and, more especially, to prevent a country from being 'drained' of such gold and silver as it had got, was for the government of that country to watch over and manipulate its foreign trade so as to keep it from having a 'wrong' balance.

I need not waste time over the first of these delusions. Adam Smith killed it, and it is not now held even by the American Federal Reserve Board and the Bank of France, though those institutions have acted as if they did believe in it. But pray don't credit those white-washers of our ancestors who allege that it never was widely accepted. It certainly was, even, strange as it appears, in countries which were the sources of the precious metals. Spain and Portugal wanted to keep all the gold and silver which was produced within their dominions, and not to part with a single ounce of it.

The other delusion, that foreign trade must be watched and manipulated in order that precious metal may be gained and retained, still survives among the vulgar, and has begotten a child as bad as or worse than itself, which has recently been harboured in higher circles.

Of course it is true that if imports and exports, *including* gold, must be equal, the difference, if any, between the value of the imports and exports other than gold must be made up by a 'balance' of imported or exported gold. But the same thing is true of any other article of commerce. If the imports and exports including gold and lead must be equal, then any difference between the imports and exports *excluding* lead must be made up by a balance of lead. Where the delusion comes in is in supposing that the way to secure the required 'favourable' balance of gold is to pull the trade in other things this way and that instead of adopting the much more simple and obvious plan of offering a sufficient value of other things in exchange for the required metal. When a country which does not produce lead wants lead, it does not propose to secure a sufficient supply by restricting and hindering imports of all things other than lead and encouraging exports of all things other than lead. It takes the much more effectual course of offering an attractive price for the lead it requires. And it is never afraid of being 'drained' of its lead by an 'unfavourable' balance of trade; it recognizes that owners of lead in the country will only part with it to foreigners if the foreigners will give them more for it than it is worth at home; and that as the foreigner buys and takes away more and more of it, the lead remaining will become of higher and higher value at home, so that the 'drain' or 'loss' of lead will stop at some early stage long before all the lead is 'drained away'. The fact of a particular metal being used as the material of money cannot exempt it from the ordinary laws of value. If a country makes its money of gold or lead, and reckons prices in what are practically weights of gold or lead, that will not prevent it being able to acquire just as much of the money-metal as it chooses to give the market value for, this value being, of course, measured in things other than the metal itself. Every ounce of the metal in the countries which do not produce it must have been brought or sent there by persons who wanted commodities or services in exchange for it, and who sent much or little according to the demand. Once inside such a country, the metal will remain there without 'flowing' or 'being drained' away so long as the foreigners do not offer more commodities and services for it than it is worth at home, and if they do acquire some of it by offering more, the process will come to an end long before all or indeed any large proportion is 'drained away', i.e. given to the foreigners in exchange for goods and services. The process will come to an end because the more currency that goes the higher will rise the home value of what remains.

After Hume all intelligent people accepted this view of the matter. They saw that unless paper substitutes took the place of gold withdrawn, the contraction of the currency caused by the withdrawal must raise the value of the gold currency remaining and check further withdrawals, so that if the currency was kept sound, no one need fear that the 'balance of trade' would carry it away.

But as time went on it became less and less approximately true that the whole of the goods and services coming to a country must be equal in value to those going from it, no matter whether short or long periods are under consideration. Large payments unbalanced by equally large payments in the opposite direction came into vogue. In the Napoleonic Wars this country sent out large quantities of cloth to clothe the armies of her Continental Allies which were paid for by subsidies voted by the British Parliament, i.e. the country taken as a whole gave away that amount of exports without getting any return of a more tangible character than an uncertain gratitude and a delusive sense of increased security. Irish landlords, apprehensive of being shot, came over to live in Cheltenham, and so much of their rents as didn't go to pay their agents for their work and risks came over to England in the shape of butter and eggs. Irish emigrants to the United States, on the other hand, would send the old people in Ireland a few of the dollars which they earned, and these dollars would buy wheat or something else from the United States, which would thus get nothing in return except the old people's letter of thanks. Then foreign investment became a still greater disturbing factor. New countries began to borrow money and issue shares for money in the old countries; the money raised was spent in the old countries on rails and locomotives and such-like things which thereupon swelled the exports of the old countries without causing at once any counterbalancing import. If, indeed, as sometimes happened, the borrowing country promptly failed to pay any interest, nothing was ever imported into the lending country to balance the exports from it; if interest was paid, it was paid in subsequent years, and if it went on long enough, it did not stop at balancing but in the long run was indefinitely greater than the original export; and of course if it went on for a limited time and then the capital was paid off, the investing country received more than it sent out during the whole period.

In this, the modern state of affairs, the rich old countries came to receive quite regularly more than they gave, because though they made many bad investments, on the whole their foreign investments paid a moderate rate of interest, and in time this interest had become big enough to exceed their annual new foreign investments. Then the value of their imports regularly exceeded that of their exports, and the excess was of course just the good which they got from having invested abroad. What would be the good of investing abroad unless sooner or later such a surplus was received? If you invest £1,000 in Argentina, what do you do it for except to get something annually from Argentina? The Argentines will pay you your dividends or interest in wheat and beef exported to England. 'What?' you say, 'me receive dividends in wheat and beef? Nonsense! I'm paid in *l. s. d.*' No doubt, but how do the Argentines get *l. s. d.* to pay you? Obviously by sending wheat and beef here to be sold and then handing you the proceeds in *l. s. d.*

While the rich old countries thus received pretty regularly more than they gave, the countries in which their foreign investments were made, taken all together, gave out more than they received. But taken separately, each of them did not always show a steady excess of outgoings, because each of them had occasional bursts of large borrowing during the continuance of which the new borrowing would exceed the interest paid on the old obligations; during these periods, which might last for many years, the imports into that country would exceed the exports; then, when borrowing slackened or stopped, the exports would exceed the imports. Such fluctuations were very distinctly observable in the Australian statistics.

In this modern world where investment overleapt international boundaries, there was clearly no longer any justification for assuming equality between the imports and exports of any country, and 'the balance of trade' became a misleading expression. No one tries to think of the Isle of Wight's 'balance of trade'; we think of the island quite simply as having no exports worth mentioning, and having very large imports because people living in the island have incomes secured in Great Britain and other places outside the island, and they draw these incomes into the island in the shape of many articles of food and drink, every scrap of the materials of their clothing, &c. But the hide-bound traditionalism of the nineteenth century prevented the entities called 'countries' (which are generally areas having customs barriers and consequently statistics of imports and exports) from being treated in the same simple and intelligible way as we treat the Isle of Wight. People went on talking about 'the balance of trade', and even kept up the old practice of calling an excess of exports a 'favourable' and an excess of imports an 'unfavourable' balance. The more intelligent, indeed, said that 'favourable' and 'unfavourable' were technical terms which no longer carried their ordinary signification, and they managed to get the general public in the rich old countries to submit to a steady predominance of imports. The submission—a rather grudging submission—was due largely to the invention of a phantom called invisible exports and imports. The public was led to believe that, though recorded imports and exports did not balance, there were unrecorded or 'invisible' imports and exports in addition, which when added into the account would make it balance. To treat various services rendered as unrecorded imports and exports the value of which should be added to that of the recorded imports and exports, and called 'invisible' imports and exports, was defensible. But it was quite absurd to call the registration of a person's name as an owner of colonial or foreign stock, or even 'scrip' issued to owners of colonial and foreign bonds, an 'invisible import' counterbalancing the export of locomotives and rails bought with the loan, and to call the letter in which Biddy O'Callaghan thanked her son Pat for sending her ten dollars from Chicago an invisible export to be set down at £2 1*s.* 1*d.* in the British account. What exactly is the 'invisible export' from the Isle of Wight which counterbalances the import of all the things bought by people in the island with incomes accruing on the mainland was never explained. But the public's uneasiness about the balance of trade was somehow lulled when it was told, 'Oh, but you mustn't look only at the recorded imports and exports; you must include the invisible imports and exports, and then you'll find the account balance all right!'

This very confusing application of the term invisible imports and exports to things which were really neither invisible nor imports and exports, did nothing to disabuse the public of the traditional belief in the beneficial character of exports, and the pernicious character of imports. Of old exports had been looked on as beneficial because they brought in gold and silver, and imports as evils—necessary sometimes, but still evils—because they tended to take gold and silver out. This view was now abandoned by all except the most ignorant, but the new method of drawing up accounts of the external relations of countries suggested to the common man that exports were good because they tended to pay off monetary obligations of the country and imports were bad because they tended to increase those obligations. So firmly rooted was the belief that it was better to give to the foreigner than to receive from him that even ardent free-traders would defend imports not on the ground that it is a happy thing to receive goods and services and the less you pay for them the better, but because, as they put it, 'if you don't import you won't be able to export!' As if to send out goods and services and get back as little as possible was the ideal. And quite recently the governments of more than one country have been found willing to guarantee that the government of another country will eventually pay for exports sent to it on credit, although that country has completely and continuously repudiated older debts.

The consequence of the continuance of the old bias against imports and in favour of exports was that a new delusion took the place of the old delusion that gold and silver would be lost unless the balance of trade was regulated. The large class of people who spend their time in arguing that their country is going to the dogs began to take every opportunity of raising a scare that their country was not really able to pay for all the imports it was taking, and either was or soon would be paying for them by running into debt to the foreigner—a course, which, they said, could only end in some rather unexplained phenomenon called 'national bankruptcy'. They conceived their nation as being in the position of a private individual who runs up enormous unpaid bills with his butcher, his tailor, and his garage, and eventually goes into liquidation and pays sixpence in the £. Great Britain, for example, would be conceived as receiving wheat on tick from Western Canadian farmers, beef on tick from Argentine ranchers, tea on tick from Ceylon planters, and so on, and eventually being obliged to confess inability to pay. *Who* exactly would be unable to pay, and why whoever was unable to pay for what he had got should not be allowed to go bankrupt in the ordinary way was never explained.

A few moments' consideration will suggest that the very best time for raising a scare of this kind is when the countries in which the rich old countries have invested capital are doing badly. Then the dividends paid by them to the investors in the old countries shrink, and default is made on some of the interest payable, so that the amount paid to the investors in the rich old countries become less; and it is easy to suggest that it will become less still. The scaremongers then rush about the rich old countries declaring that it is already difficult, and will soon be impossible, for them to pay for their imports. The balance of trade, they say, must be 'redressed', and it is necessary to subsidize exports and impose duties or prohibitions on imports, or the country will be buying more imports than it can pay for, and consequently be on the high road to national bankruptcy. Now if the same thing happened to the Isle of Wight, that is, if the property which inhabitants of the island own outside the island began to yield less income than before, we might be sorry for those Isle of Wight owners of property, but we should not worry at all about the island's balance of trade. We should simply take it as the natural thing that those persons in the Isle of Wight whose incomes were reduced would spend less and invest less in and out of the island. If they could and did counterbalance the whole reduction of their income by not investing as much as they used to do outside the island, nothing would happen to the movement of goods across the Solent; if they could and did counterbalance the whole reduction of their incomes by cutting down their expenditure on things brought into the island, the simple result would be a reduction by that amount of the imports; if they met the whole reduction of their incomes by reducing their expenditure on new potatoes and other things produced in the island, people in the island would sell these things to the world outside the island, so that the loss on income derivable from outside would be counterbalanced, and imports paid for as usual. It is quite certain that there would be no appeal to the County Council of the Isle of Wight to get parliamentary powers to give bounties on exports and impose duties or prohibitions on imports in order to 'redress' or 'put right the balance of trade and save the island from bankruptcy'.

There is no conceivable reason for supposing the case of Great Britain or any other great country to be different from that of the Isle of Wight as we have just described it. If the income from foreign investments falls off, the balance of trade will 'redress' itself so far as is necessary without any of the politicians' impertinent and ignorant attempts to assist it to do so.

But reduction of income from abroad is not the only thing likely to help the scaremongers when the new countries are relatively less prosperous. In such times these countries offer relatively less attraction to investors in the old countries, who therefore are more inclined to put their new savings into something in their own country. This change will necessarily depress the exports of the old countries. If any of us here lend money to or invest in Australia or Argentina instead of investing it here, exports will go to those countries which otherwise they would not have been able to pay for. We may think if we like of ourselves as posting banknotes to Australia or Argentina, but if we did the notes would be sent back to buy something in the old country where they circulate freely. Conversely a diminution of fresh foreign investment tends to depress the exports from the old country and increase the excess of imports into it. Then the balance-of-trade scaremongers start lamenting the diminution of the exports as if it was the result of *incapacity* to save and invest instead of merely a sign of preference for home as against foreign investment.

Applying our Isle of Wight example once more, would it not be absurd to lament the widening of the gap between the island's exports and imports if that widening were caused by relative prosperity in the island which led to the people there investing their savings in new lodging-houses and hotels there instead of in new investments on the mainland?

I can fancy somebody saying, 'Why all this general elementary stuff? What John Bull wants is to be told about his condition at the present moment'. But if he wants that, my reply to him is *De te fabula narratur*. We are passing through exactly one of those phases which I have been describing as so favourable to the balance-of-trade scaremonger. The decline in the rate of growth of population over the civilized world is tending to worsen the position of the primary producers who provide the coarse necessaries of life, and various improvements in agricultural and other primary production also tend in that direction. The inducement to open up new areas and extend cultivation and occupation has greatly diminished. Openings for new capital and industry are now tending to be more and more in the production of the semi-necessary luxuries and refinements of life than in the production of the coarser necessaries, and these luxuries and refinements are likely to be produced in the rich old countries rather than in the poor and new countries. As if this was not enough, some of the most important of the undeveloped countries have done their best to hamper their own development by imposing all sorts of trammels on commerce and by actually refusing to admit immigrants able and willing to work. Then, when their miserable policy, joined to the unavoidable conditions, has brought them into some difficulty, many of them have naturally begun to pay worse dividends or none at all on capital invested in them by the old countries, and some of them have failed to meet definite obligations to lenders in the old countries.

No wonder then that investors in the rich old countries have preferred to keep more of their savings at home!

I will not quarrel with any one who says that these savings have somewhat diminished since the pre-war period. It would be rather astonishing if they had not diminished, in view of the enormous redistribution of wealth which has been effected by the post-1914 increases of income-tax, super-tax, and death duties. The easiest and least thankless method of dealing with a very large income is to invest a large proportion of it, and even with moderate incomes the rule is that the bigger they are the larger is the proportion likely to be saved. Redistribute net income in the direction of taking from the rich and giving to the poor, and you are pretty certain to diminish savings. Moreover, there is some justification for less savings in the diminished rate of growth of the population; an equal population does not require so much new capital as an increasing one. Of course the average citizen does not think about that, but if he has only one or two children or none at all he is likely to be less inclined to leave much behind him than if he has half a dozen, though of course it may be easier for him to do so.

But even if savings have somewhat diminished and, what is more doubtful, have diminished more than is reasonable under the circumstances, how perfectly ridiculous is the assumption of those (some of them in quite high places and with immense reputations for mental ability) who talk of us as 'living on our capital', as if we had not been adding enormously to our capital!

Remember that the important thing is not how much individuals have subscribed to new issues on the stock exchange, but now much has been actually added to the useful property of the whole community. In recent years no doubt we have misspent much of the money raised by the motor-vehicle licences, but at any rate we have more now to show for the money than we have to show for the money subscribed in the eighteen-eighties on Russian bonds. The statistics of savings commonly put forward ignore losses, and are apt to omit accretions to property which are paid for out of rates and taxes or out of what the individual regards as expenditure rather than savings. To get a true estimate of what is going on you must look at the property itself and consider whether it is greater or less. Looking at the actual material equipment of the country, can any of us who remember what it was thirteen years ago have the least doubt that it is enormously bigger and better? What proportions of it can be supposed smaller or worse than in 1918? Some industries are suffering considerable depression, but it would be difficult to find even one of these with smaller or worse equipment than it had in 1918. The mines, cotton mills, and shipyards have as great a productive capacity as they ever had; the railways have more. In most other directions the increase and improvement of material equipment is undeniably enormous. What of the wider, smoother, and dustless roads? What of the millions of additional motor-vehicles which crowd them, and the works at which these vehicles are made and the garages in which they are stored and repaired? What of the millions of new houses which have been built, and the improvements of the old ones? What of the additional and improved furniture and fittings of the houses—the wireless sets, gramophones, telephones, and all the other things almost unknown at the beginning of the century? What of the additions to the equipment of buildings and apparatus for new and old schools and universities?

Does any one pooh-pooh these things as trivial, and say we don't want these luxuries and refinements but more food? Of him I would ask, 'Are we then swine demanding nothing but more and more hogs' wash? Is it not luxuries and refinements that we live for? Are we short of food? Is not the great cry of a large section of the scaremongers that we are getting our food too cheap?'

Difficulties we certainly have. In common with most of the civilized world we have the great difficulty which arises from the stupid desire of central banks, backed by legislatures and nationalist public opinion, to hoard the standard of currency and thereby raise its value. We are the special prey of the too ingenious bureaucrats who, 'immured in Whitehall', devise schemes which, at any rate as botched by the politicians at Westminster, sap the existing incentives to industry and good conduct without putting any substitute in their place. And thus we manage to throw away more than ten per cent. of our productive power.

But even so we manage to carry on, and whether on or off the gold standard we certainly shall not benefit by reviving the three-hundred-year-old and long-ago-exploded superstition that the balance of trade must be watched over and kept right by Parliament—a superstition which can only be ranked with the once equally widespread belief that witchcraft must be smelt out and witches burnt at the stake.

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