



Box 38-2

The Volume of Trade, the Balance of Trade, and the New Mercantilism

Media commentators, political figures, and much of the general public often judge the national balance of payments as they would the accounts of a single firm. Just as a firm is supposed to show a profit, the nation is supposed to secure a balance-of-payments surplus, with the benefits derived from international trade measured by the size of that surplus.

This view is related to the exploitation doctrine of international trade: One country's surplus is another country's deficit. Thus one country's gain, judged by its surplus, must be another country's loss, judged by its deficit.

People who hold such views today are echoing an ancient economic doctrine called *mercantilism*. The mercantilists were a group of economists who preceded Adam Smith. They judged the success of trade by the size of the trade balance. In many cases this doctrine made sense in terms of their objective, which was to use international trade as a means of building up the political and military power of the state, rather than as a means of raising the living standards of its citizens. A balance-of-payments surplus allowed the nation (then and now) to acquire foreign exchange reserves. (In those days the reserves took the form of gold. Today they are a mixture of gold and claims on the currencies of other countries.) These reserves could then be used to pay armies to purchase weapons from abroad, and generally to finance colonial expansions.

People who advocate this view in modern times are called *neomercantilists*. Insofar as their object is to increase the power of the state, they are choosing means that could achieve their ends. Insofar as they

are drawing an analogy between what is a sensible objective for a business, interested in its own material welfare, and what is a sensible objective for a society, interested in the material welfare of its citizens, their views are erroneous, because their analogy is false.

If the object of economic activity is to promote the welfare and living standards of ordinary citizens, rather than the power of governments, then the mercantilist focus on the balance of trade makes no sense. The law of comparative advantage shows that average living standards are maximized by having individuals, regions, and countries specialize in the things that they can produce comparatively best and then trading to obtain the things that they can produce comparatively worst. The more specialization there is, the more trade occurs.

On this view the gains from trade are to be judged by the volume of trade. A situation in which there is a *large volume* of trade but in which each country has a *zero balance* of trade can thus be regarded as quite satisfactory. Furthermore, a change in commercial policy that results in a balanced increase in trade between two countries will bring gain, because it allows for specialization according to comparative advantage, even though it causes no change in either country's trade balance.

To the business interested in private profit and to the government interested in the power of the state, it is the balance of trade that matters. To the person interested in the welfare of ordinary citizens, it is the volume of trade that matters.