International economic relations
In modern form

The theoretical basis of a study of international economic relations in its modern form was formed as a result of a long and difficult process, full of succe sses but, nevertheless, with important mistakes.

The early roots are to be found, perhaps, in Antic Greece in the works of Aristotel, Platon and Xenophon. In general, the antic philosophers opposed to the big commerce, supporting the idea of a closed domestic economy. The closed character of the production of a self-supply type, dominating from the antiquity up to 15th century gave no incentives for developing any profound and constant studies on international trade. In these conditions is in no way occasional that the theorists of antiquity and Middle Ages (scholastics) exaggerated the role of production (especially agricultural) and pleaded against the "art of making money", the chrematistics (after Aristotel).

At the dawn of the Modern Age (16th century) there appeared the first trials of more systematic analyses of the international economic relations.

Developed during the period of the downfall of feudalism and the transition to capitalism, the mercantile theory was the first trial to explain integrally the principles of international trade in a paradigm of the analysis of economic reality.

Perhaps, the field of international trade was first closely studied by men of affaires, in private or governmental employment, as no other topical area, as a part of an effort to increase the wealth and the power of the nation, with which these men tended to identify their own welfare. This body of doctrines, later named by Adam Smith the "mercantile system" or "mercantilism", insisted that the acquisition of wealth, particularly wealth in the form of gold, was of paramount importance for national policy. Mercantilists took the virtues of gold almost as an article of faith; consequently, they never undertook to explain adequately why the pursuit of gold deserved such a high priority in their economic plans.

The mercantilists held that economic policy should be nationalistic and aim to secure the wealth and power of the state. This concept was based on the conviction that national interests are inevitably in conflict - that one nation can increase its trade only at the expense of other nations.

Thus the most pervasive and most emphasized doctrine was the importance of bringing about and maintaining an excess of exports over imports, for that was the only way for a country without gold and silver mines to increase its stock of the precious metals. In this way the foreign trade, after mercantilists, was reduced to the maximum exports of goods for gold and silver and some exports of raw materials and precious metals.

The desire for a "favorable" balance of trade was never based by mercantilist writers on a to see their countries engaged in capital export, to make investments abroad, as the majority of them were at least confused as to the difference between money and wealth, and very often identified these two terms.

The idea was also that the state should provide its citizens with a monopoly of the resources and trade outlets of its colonies. A typical illustration of the mercantilist spirit is the famous English Navigation Act of 1651, which reserved for the home country the right to trade with the colonies and prohibited the import of goods of non-European origin unless transported in ships flying the English flag. This law lingered on until 1849. A similar policy was followed in France.

Thomas Mun

Thomas Mun, as a representative of mercantilist school, was one of the firsts to deal extensively with the balance of international trade and the balance of international payments. He first introduced into this balance such components as the sale of numerous services - freight earnings, marine insurance payments, travelers' expenses, and many more - to foreign countries.

Among other adepts of mercantilist theory we can name also Edward Misselden, William Petty, and others.

With the emergence of mercantilism in the 16th-17th century, an extensive body of literature dealing with the international trade appeared, although we must add immediately that it yielded relatively few lasting contributions to international trade theory.

Mercantilists' ideas often were intellectually shallow, and indeed their trade policy may have been little more than rationalization of the interests of rising merchant class that wanted wider markets coupled with protection against competition in the form of imported goods.

Liberalism

A strong reaction against mercantilist attitudes began to take shape toward the middle of the 18th century. In France, the economists known as Physiocrats demanded liberty of production and trade. In England, Adam Smith demonstrated in his The Wealth of Nations (1776) the advantages of removing trade restrictions. Economists and businessmen voiced their opposition to excessively high and often prohibitive customs duties and urged the negotiation of trade agreements with foreign powers.

This movement was later named liberalism and the very first economists fighting against the mercantile ideas are regarded to as the pre-classical liberalists.

Pre-classical Liberalism

18th century is often remarked through the development of the scientific trend in studying human society. In this way through the association with such sciences as physics, medicine, astronomy, and others, it was proved that the society is ridden by the "natural law". Instead of being finalistic and normative, as in the Middle Ages, the human sciences became descriptive and explanatory. One of the first scientists which tried to follow these concepts are the pre-classical liberalists and among them such economists as Dudley (Douglas) North, Cantillon, Hume, Condillac, and others.

Dudley North

North undertook a vigurous attack aimed at ridding the discussion of foreign trade matters from mercantilist "superstitions". He has fittingly been called the first "free trader" in the Smithian sense. Viewing the whole world rather than a single nation as an economic unit, he demonstrated that there's no fundamental difference between foreign and domestic trade. North also presented a concise formulation of the automatic and self-regulating mechanism that provides a nation with that sum of money required for carrying its trade.

Cantillon

Cantillon deflated mercantilist tenets by showing that if a country continues to sell more than it buys from abroad, money will successively will flow into it and, as a

first consequence, land and labor in the export-surplus country will become more expensive.

Hume

Hume greatly helped to piece together the theory of self-regulating international trade, and he went beyond Cantillon in pointing out why a country could not permanently have a "favorable" or "unfavorable" trade balance. Specifically, he stated the theory of self-regulating mechanism with a much greater degree of clarity and incorporated it more consistently with the remainder of his work than was the case with any of the earlier or contemporary writers. He included the influence of exchange-rate fluctuations on commodity trade in the mechanism as an additional equilibrating factor. Hume considered that the exchange rate equilibrates the trade balance of the country; this meaning that it grows, if the trade balance tends to the unfavorable one and in this way presses the imports, and vice-versa.

Condillac

Condillac applied his utility theory to international trade and demonstrated that what holds true for exchange between two persons is largely applicable also to commerce between nations. The inequality of subjunctive valuations he saw reflected, on a larger scale, in the total exchange transactions between nations. He decried the foolishness of establishing trade barriers because it is in the very nature of exchange that both parties will benefit - what is offered for sale always being valued less highly than what is acquired in return. If each nation insisted on selling only, they would all eventually wind up without foreign trade and deprive themselves of its benefits. Condillac went beyond his predecessors Hume and Cantillon in showing that even if other nations continue putting up obstacles to international exchange, it will be advantageous for a particular country to adhere to free-trade principles. He concludes, somewhat optimistically, that when trading enjoys complete and permanent liberty, wealth is bound to spread everywhere.

Classical Liberalism

Classical liberalistic school gave us three models of international trade:

- **the physiocratic model**

- **the absolute advantage theory**
- **the theory of comparative advantage**

Physiocratic model

The mercantile policies imposed in the 16th - 17th century, which proclaimed the accumulation of wealth through trade, in the form of money capital, had ridden the most of European countries (maybe except Germany and, in some measure, Britain) into a state of a downfall of production, especially of agricultural one.

Gradually there appeares the idea that the wealth consists of goods. In this sense, physiocrats can be considered the pioneers. Supporting that the wealth is the totality of agricultural goods, physiocrats leave money the role of a means of exchange only.

In these conditions, the new conception about the international trade appears. Once the wealth derives from agriculture, it is not created by trade, therefore the trade must be based only on the exchange of equivalents, while money are no more than a means of exchange.

The physiocrats oppose to the active ("favourable") balance, as it results from the export of wealth (in the form of goods), and the import of money (which are not wealth). They fight to realise an equilibrated balance in international trade.

Quesnay

The founder of the Physiocratic School, Quesnay, in all probability heavily indebted to Cantillon, brought out the fact that the state of the balance of trade between nations is neither an indicator of the advantages of foreign commerce nor that of the wealth of nations. But he was the author of theory which contained the idea that when a country imports luxury goods, selling the most necessary or most useful commodities, it prospers, because it means that the people are able to produce beyond its basic requirements.

The Absolute Advantage Theory

The British school of "classical economics" began in no small measure as a reaction against the inconsistencies of mercantilist thought. Adam Smith was the 18th-century founder of this school; his famous work, "The Wealth of Nations", is in part an

anti-mercantilist tract. In "The Wealth of Nations", Smith emphasized the importance of specialization: in a world where the productive resources are scarce and human wants cannot be completely satisfied, each nation should specialize in the production of goods it is particularly well equipped to produce; it should export part of this production, taking in exchange other goods that it cannot so easily turn out.

Adam Smith

Adam Smith's attack was probably the boldest one on the "mercantile system" which was already tottering both because economic changes had given some of these doctrines an antiquarian flavor and because the piecemeal invalidations of these doctrines by the many forerunners of economic liberalism hardly left it a "leg to stand on". All the same, without Smith's vigurous, forceful, and systematic statement of its weaknesses, it might have lingered much longer than it did.

On the other hand, Smith was unfortunately not capable of precisely formulating a general theory of international trade. Apart from his building up an imposing structure of arguments in favor of freedom from restrictions on foreign trade activities, his contributions to this theory are relatively minor, as Smith considered mistaken that a producer needs an absolute advantage to export its products.

The basic concepts of Smith's teory of international trade may be considered the following:

1. The international commerce is close related with the social division of labor.

2. The international trade after Smith is based apon the freedom of action and the incentives of economic agents.

3. In international trade the competition is free and perfect (without monopolies and any governmental restrictions in the form of protectionist policies).

From these concepts the following indications on international economic relations result:

1. In the result of labor division it is not necessary and even possible that every country produce inside all the products it needs. It is because different states are provided with the factors of production of different types and quality in different proportions. As the result every country must specialize in production of that goods, for which the costs of production are the lowest.

2. Every country imports the goods for which it pays a lower price than it would cost him in case it produced this product domestically.

3. The difference between the domestic cost of production and the import price is the absolute advantage obtained through the international trade, this rule being general for all countries.

4. At the domestic range the state must not interfere in economy, as it always disturbs economic agents from seeking the most efficient mode to invest factors of production it posesses.

5. In the international trade must be promoted the policy of free competition (without monopolies) and a policy of free exchange (non-discriminating).

Much as Smith was aware of the benifits of free trade and was able to influence the British economic thought, he was not an unqualified free trader. He singled out two primary cases which in his view justified the imposition of barriers on imports for the purpose of encouraging domestic industry.

First, some particular industries may be necessary for the defense of a country. From this point of view, the British Navigation Acts, inasmuch as they promoted the building up of a merchant marine to be used in peace and war alike, were perfectly sensible.

The second case is an application of the principle that normally competitive conditions should not be distorted by government intervention. Consequently, it will be proper to place a burden on foreign industry if this merely neutralizes the disadvantage under which domestic industry operates because it is burned with some taxes from which the foreign producers are exempt. After the imposition of a "matching" tariff duty, a form of equalizing adjustment no larger portion of domestic labor and capital would be devoted to the particular domestic industry of a country than what would naturally go to it. "It would only hinder any part of what would naturally go to it from being turned away by the tax, into a less natural direction..." Smith does not underrate the difficulty arising from the fact that imported commodities are seldom perfect equivalents of the domestic produced variety.

Adam Smith took up two secondary cases in which he held it to be a "matter of deliberation" whether or not to follow a laissez-faire policy.

The first deals with the advisability, pro and con, of imposing a retaliatory duty designed to bring about the repeal of a duty imposed by a foreign country. The success

of taking such a step, Smith holds, will always be open to guess; and unless the odds are distinstly in its favor, the "...transitory inconviniency of paying dearer during a short time for some sorts of goods" would not be justified.

The second possibility, where the issue is not the imposition of a new tax but rather the return to free trade from the evils of protection, centers around the need of preventing a sudden painful shock to a domestic industry. This will be largely a question of size: only when a "great multitude of hands" would all at once be deprived of their ordinary employment and livelihood by the removal of high duties and prohibitions in some special regard to their welfare in order. Indeed, Smith feels, it becomes a matter of equity in this case that the return to exposure to competition from foreigners be undertaken "...slowly, gradually, and after a very long warning".

Bounties on exports, that is, government payments to exporters of goods who could not otherwise effectively compete with their foreign rivals, were, as we might expect, another device of the "mercantile system" scorned by Smith. They can only warp the natural allocation of resources. Since a country cannot force the buying of its exports on other countries, the next best expedient may be found in one country paying another for the buying of exports. But doing so, through bounties, will force a country's trade in less advantageous channels than that in which it would go if left alone. Domestic consumers will be the losers: under conditions of full employment they would pay a higher price for a smaller portion of the total supply, and in addition they would have to foot the bill for government payments to exporters.

Such are the highlights of the attack on the absurdities of mercantilist restrictions, which had flowered too long to suit Smith's disposition.

The Comparative Advantage Theory

Smith did not expand these ideas at much length; but David Ricardo, the second great classical economist, developed them into the "principle of comparative advantage", a principle still to be found, much as Ricardo spelled it out, in every textbook on international trade.

The principle of comparative advantage is based on what kind of product the country can produce best, in comparing not with other countries, but with the producing of other kinds of goods. In this case the country doesn't necessarily need an absolute advantage to specialize in producing and exporting it.

The major purpose of the theory of comparative advantage is to illustrate the gains from the international trade. Each country can gain by specializing in those occupations in which it is relatively efficient; it should export part of that production and take in exchange those goods in whose production it is, for whatever reason, at a comparative disadvantage. The theory of comparative advantage thus provides a strong argument for free trade - and indeed - for a laissez-faire attitude with respect to trade.

The supporting argument is simple; specialization and free exchange among nations yield higher real income for the participants.

The act that a country will enjoy higher real income as a consequence of the opening up of trade barriers does not mean, of course, that every family or individual within a country must share in that benifit. Producer groups affected by import competition obviously will suffer to at least some degree. Comparative-advantage theorists concede that free trade would affect the relative income position of such groups, and perhaps even their absolute income level. But they insist that the special interests of these groups clashes with the total national interest, and the most that they are usually willing to concede is the possible need for a temporary protection against import competition, in order that the persons affected may have sufficient time to move to another occupation.

David Ricardo

In his theoretical researches D.Ricardo did not base apon extensive empirical researches but mainly engaged in abstract reasoning. In working out his international trade theory, he also founded his conclusions apon a set of postulates which he considered as first approximations of the real world. The conclusions he drew, being valid within the framework of his assumptions only, had of course to be modified before they could be applied to actual circumstances.

The same is also true for Jean-Stuart Mill, whose studies in international trade theory completed the framework built by Ricardo. In spite of many attacks and emandations, the main structure of the Ricardo-Mill theory of international trade remained basically unimpared untill well into the 20th century.

He left however, much unfinished business for his successors, since his statements did not explain how the actual ratios of international exchange determine international prices.

Ricardo has been attacked on many grounds: his statement of the doctrine in terms of labor costs only; his assumption of constant cost of production; and, of course, his artificial assumptions of perfect factor mobility within a nation as against complete factor immobility internationally. Many feel that these demerits are minor and are overshadowed by the fact that his new approach opened up entirely new vistas for further research, for example, a restatement of the principle in terms of opportunity costs.

John Stuart Mill

Ricardo's contribution left unanswered the question of how the actual ratios at which goods exchange are determined. It was Jean Stuart Mill who explained the determination of the terms of trade and did so with great skill. He found that they are dependent on reciprocal demand and that the equilibrum exchange ratio is the ratio that equalizes the values of exports and imports for each country in a two-country two-commodity situation. With the "Equation of International Demand" as a tool, he proceeded to envisage more complicated situations and explain what modifications in assumptions their analysis necessitated. His work helped greatly in clarifying the intricate problems connected with the theory of international values and strengthened the foundations on which others could build.

Among the other representatives of classical school we can pick up such economists as Nassau William, Senior, John Elliot Cairness, the Irish one Charles Francis Bastable, whose apport in developing theory of international trade was, perhaps, the boldest, as they tried to modify the Ricardo-Mill theory in more realistic way.

This change of attitudes led to the signing of a number of agreements embodying the new ideas, among them the Anglo-French Treaty of 1786, which ended what had been an economic war between the two countries.

After Adam Smith, the basic tenets of mercantilism were no longer considered defensible. This did not, however, mean that nations abandoned all mercantilist policies.

Restrictive economic policies were now justified by the claim that, up to a certain point, the government should keep foreign merchandise off the domestic market in order to shelter national production from outside competition. To this end, customs levies were introduced in increasing number, replacing outright bans on imports, which became less and less frequent.

In the middle of the 19th century, customs walls effectively sheltered many national economies from outside competition. The French tariff of 1860, for example, charged extremely high prices on British products: 60 percent on politique economique ig iron; 40 to 50 percent on machinery; and 600 to 800 percent on woolen blankets. Transport costs between the two countries provided further protection.

A triumph for liberal ideas was the Anglo-French trade agreement of 1860, which provided that French protective duties were to be reduced to a maximum of 25 percent within five years, with free entry of all French products except wine into Britain. This agreement was followed by other European trade pacts.

Resurgence of Protectionism

In the period of a whole triumph of the doctrine of classical economic liberalism, in the first part of 19th century, there appears in Germany a diametrically contraire (at least apparently) doctrine of economic protectionism. The brightest representative of this new theory is, no doubt, Friedrich List (1789-1846), son of a German leatherworker. Not studying at any university, he made an academic career to become active in German politics. In 1819, he became leader of the General Association of Manufacturers & Merchants and the very soul of the movement to confederate the German states.

Being controversed and pressed in course of his life, list was in no smaller measure appreciated and valued posthumously. Rare economists had such a great influence upon the course of economic events as List had, there are few systems of economic thought which were to such extend using in practice as the Listien one was.

The economic and political unity that characterized much of Europe in the first half of 19th century was totally absent from Germany. The peace treaty that ended Germany's participation in Napoleonic wars left that country divided into 39 different states, most of which were individual monarchies economically and politically isolated from one another. Such isolation was primarily the result of a complex system of interstate tariffs that impaired the free and easy exchange of goods. At the same time, however, no import duties existed. Thus British surplus products (and those of other countries) found their way into German markets, where they were offered at extremely low prices.

Under these circumstances the very existence of German manufacturing and mercantile interests was threatened, and by the 1830, there arose among the German states a general clamor for economic unity and uniform tariffs. It was this movement that consumed List's interests and energy.

In his analysis of national systems of political economy, List applied a method of inquiry originated by Saint-Simon: the idea that an economy must pass through successive stages before it reaches a "mature" state. The historical stages of development detailed by List were:

1. Barbaric
2. Pastoral
3. Agricultural
4. Agricultural-Manufacturing
5. Agricultural-Manufacturing-Commercial

Like Sismondi and Saint-Simon, List was as much interested in transition between stages of economic development as in the end result. He felt that passage through the first three stages will be brought about most speedily by free trade between states and nations, but that economies in transition between the last two stages required economic protection until the final stage was reached.

Free trade justified once again, however, when the final stage of development was attained, "in order to guard against retrogression and indolence by the nation's manufacturers and merchants".

By List's classification and testimony, only Great Britain had attained the final stage of economic development. While the Continental and American nations struggled to reach this apogee, however, cheap British imports were thwarting the development of domestic manufacturing. List felt that until all nations reached the final stage of development, international competition could not exist on an equal footing. Thus he favored protective tariffs for Germany until its greatest national economic power was attained.

It is important to note that List was not an outright protectionist; rather, he felt that protection was warranted only at critical stages in history. His writings are replete with examples borrowed from history and experience showing that economic protection is the only way for an emerging nation to establish itself. List felt that the American experience offered vindication of his views, and he of course found ready support among United States protectionists, particularly Alexander Hamilton and Henry Carey.

List's Criticism of Classical Economics

List strongly opposed the absolutist, cosmopolitian tendencies of the classical economists. They derived principles, he maintained, which were then assumed to hold for all nations and all times. By contrast, List's theory and methodology were strongly nationalistic and historical. His theory of stages in economic development, for example, was calculated to demonstrate the insufficiency of classical economics to recognize and reflect the variety of conditions existing in different countries and, most especially, in Germany.

Like Sismondi, List subordinated economics to politics in general. In his view, it was not enough for the statesmen to know that the free interchange will increase wealth (as demonstrated by the classical economists); he must also know the ramifications of such action for his own country. Thus List argued that free trade that displace either population or domestic industry is undesirable. Moreover, List would not sacrifice the future for the present. He maintained that the crucial economic magnitude in economic development is not wealth (as measured by exchange values) but productive power. In his own words, " The power of producing wealth is...infinitely more important than the wealth itself". Thus economic resources must be safeguarded so that their future existence and development are assured. This view constitutes further justification for List's protectionist arguments; it also lies at the root of the popular "infant-industry" argument in support of protective tariffs.

For List, the ultimate goal of economic activity should be national development and the accretion of economic power. In this, he (as Marx was to do later) perceived industry as more than the mere result of labor and capital. Rather, he conceived industry as a social force that itself creates and improves capital and labor. In addition to effecting present production, industry gives an impetus and a direction to future production. Therefore, List recommended the introduction of industry into underdeveloped countries even at the expense of temporary loss.

List's originality in economic theory and method consisted in his systematic use of historical comparison as a means of demonstrating the validity of economic propositions and in his introduction of new and useful points of view in contradistinction to the economic orthodoxy of classical liberalism. In stretching the dynamic fabric of classical economic growth by representing economic development as a succession of historical stages, he provided a methodological rallying point for the economists of the German historical school. Thus List may appropriately be considered the forerunner of that school.

This reaction in favor of protection spread throughout the Western World in the latter part of the 19th century. Germany adopted a systematically protectionist policy and was soon followed by most other nations. Shortly after 1860, during the Civil War, the United States raised its duties sharply; the McKinley Tariff Act of 1890 was ultra-protectionist. England was the only country to remain faithful to the principles of free trade.

But the protectionism of the last quarter of the 19th century was mild by comparison with the mercantilist policies that had been common in the 17th century and were to be revived between the two World wars. Extensive economic liberty prevailed by 1913. Quantitative restrictions were unheard of, and customs duties were low and stable. Currencies were freely convertible into gold, which in effect was common international money. Balance-of-payments problems were few. People who wished to settle and work in a country could go where they wished with few restrictions; they could open businesses, enter trade, or export capital freely. Equal opportunity to compete was the general rule, the sole exception being the existence of limited customs preferences between certain countries, most usually between a home country and its colonies. Trade was freer throughout the Western World in 1913 than it was in Europe in 1970.