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The Free Trade Doctrine of the Classical Economists: No Unconditional Subscription to Trade Liberalisation[1]

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Abstract

The paper discusses the views of the British classical economists David Hume, Adam Smith and David Ricardo on international trade and trade liberalisation. While they were in favour of free trade, they did not unconditionally subscribers to the free trade doctrine, but tied it to the condition of free competition. As Adam Smith insisted with regard to the East India Company, a trading monopoly, trade was "ruinous and destructive" to India and several other countries. The German economist Friedrich List insisted that free trade cannot generally be the starting point of economic relationships amongst nations, but only the terminal point, after the nations involved had developed their productive powers and competitiveness.

Jel Codes: B12, B15, B17, B31, F54, F60

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1. Introduction

In this paper I discuss the views of the British classical economists from David Hume and Adam Smith to David Ricardo on international trade and trade liberalisation. While it is frequently contended that these economists were unconditional subscribers to the free trade doctrine, it is shown that this was not so: free trade was seen to be in principle a good thing, but only if certain conditions were met. The composition of the paper is the following.

Section 2 summarizes briefly crucial elements of what is known as the "mercantilist" doctrine of trade. Section 3 turns to David Hume's view. Section 4 deals with Adam Smith's explanation of trade specialization in terms of absolute cost advantages. Section 5 is concerned with Smith's insistence that free competition is needed for trade to be beneficial to all countries involved and his criticism of the East India Company as a particularly daunting example of the "wretched spirit of monopoly". Section 6 expounds David Ricardo's concept of comparative

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advantage. Section 7 provides a brief summary account of Friedrich List's critique of the free trade doctrine. Section 8 concludes.

The questions touched upon in this paper include: Is international trade universally advantageous? If not, who are the beneficiaries, who the losers? What kind of negative effects does it entail for whom? How large are these negative effects? Could the beneficiaries compensate the losers? When is the sum total of the benefits smaller than the sum total of costs? On what do benefits and costs depend? Which role does the market form play – from free competition to monopoly? Which factors determine the emerging patterns of specialization between regions and countries? How does technical progress affect these patterns?[3]

2. Elements of the "mercantilist" view

The historical starting point of investigations into the pros and cons of international trade is the discovery of new worlds and the attempt to compare the different living conditions across the globe and explain their causes. Pioneers in this regard included, for example, John Locke and Charles de Secondat, Baron de Montesquieu. In parallel with the beginning and swift growth of long-distance trade emerged a huge literature, which was then dubbed "mercantilist", conveying the impression of homogeneity, which, however, did not exist. But there were elements of the doctrine that were widely approved of by many authors and which found one of their most conspicuous expressions in Thomas Mun's (1571-1641) book, *England's Treasure by Forraign Trade*, published in 1621. England's wealth, Mun stressed, increases "wherein wee ... sell more to strangers yearly than wee consume of theirs in value." This involved a policy of export promotion and import restriction, a policy of privileges and "monopolies" granted to trading companies, the erection of garrisons abroad, and so on.

In book IV of *The Wealth of Nations*, Adam Smith discussed in great detail the "commercial system" and was keen to pull it to pieces.[4] But a somewhat deeper understanding of the system is possible. Here I refer only to the book by North, Wallis and Weingast (2009), who called mercantilism as the political economy of a "limited access society". Limited access via privileges, they argue, generates economic rents designed to render elites to cooperate instead of going to war. Coercion in such societies becomes institutionalised, with the unprivileged many just as "pieces upon the chess-board" that can be moved at will. The ruling maxim is "No land without a lord! No man without a lord!" Absolutism is the congenial form of government with the monarch as the monopolist supplier of grants and privileges.

International trade is conceived as a zero-sum power game. It needs to be regulated by means of corporate trading monopolies, backed by administrative and military support. These monopolies are endowed with the rights to territorial acquisitions, to command armies, to build fortresses, to mint money, to make war and peace, to watch over civil and criminal jurisdiction and to levy taxes without political representation of the taxed. Here the maxim is: "Use power to gain plenty! Use plenty to gain power!" Josiah Child expressed it in the

[3] In this paper I draw freely on some earlier works written by me alone or in collaboration with others.

[4] He was not always fair with the mercantilists and in some cases his criticism was ill-conceived. Smith had not understood that the manufacturing sector did not only produce gadgets and trinkets for the rich, but also machines for the entire economy. An industrial policy and the promotion of urbanisation were therefore not a priori bad things, as he was inclined to think.

following way: "Foreign trade produces riches, riches power, power preserves our trade and religion."

From the mid 17th century onwards trade with the colonies increased greatly in importance. The main focus was the exploitation of natural resources of the colonies, human and other. The Navigation Act of 1651 et seq. gave English vessels a monopoly in carrying goods from and to England. According to the mercantilist doctrine exports of consumption goods ought to be encouraged, whereas exports of domestic raw materials, capital goods and skilled labour ought to be prohibited. The coffers of the king were to be filled with silver and gold, because at times of increasing tensions between greedy nation states, conflicts and wars were imminent and "money is the sinews of war".

Against this Adam Smith was to put what he called "the obvious and simple system of natural liberty". It may have been obvious to him, but it certainly was not to the advocates of the "commercial system", who benefited in numerous ways from the latter (see Kurz 2019).

Smith wished the authoritarian state to be replaced by a modern productive state, which enforced the Rule of law and guaranteed property rights to its citizens, established a state monopoly on legitimate violence subject to parliamentary control, abolished privileges and secured free entry in and exit from markets and professions, prohibited slavery and was engaged in building up a meritorious society. In short, Smith advocated a radical break with the past.

3. David Hume on demonstration effects in a self-equilibrating system

In his *Essays. Moral, Political and Literary* ([1741 et sec.] 1985), David Hume (1711-1776) also wrote about economic issues and put forward ideas that had a great impact on the literature that followed. He did so especially in his essays, "Of refinements in the arts", "Of the balance of trade" and "Of the jealousy of trade". His analysis had as its backbone his empirical anthropology he had elaborated in an *A Treatise of Human Nature* ([1739-40] 1882).[5] In it he pointed out that different environments tend to activate different inclinations and capabilities of man. The unchangeable human nature is the soundboard, the environment the player that makes certain strings of human nature resonate. This feeds back on the environment. While at first the effects are small, their cumulation may involve a fundamental transformation of society. In this context, Hume put also forward his version of the doctrine of the unintended consequences of human action, which was a core doctrine characterising the Scottish Enligthenment.

According to Hume, foreign trade is a most important engine of economic and social change. He referred to two kinds of *demonstration effects* that propel development: (i) In consumption, the exposure to new goods and services is at the root of the emergence of new needs and wants. (ii) In production the acquaintance with new tools, productive resources and methods of production leads to the gradual improvement of technical knowledge and affects the system of production. In his essay "Of commerce", first published in 1752, he wrote: "Now, according to the most natural course of things, industry and arts and trade increase the power of the sovereign as well as the happiness of the subjects"; he added, however, that "that policy is violent, which aggrandizes the public by the poverty of individuals." Hence the gains from

[5] For a summary account of Hume's contribution to political economy, see, for example, Kurz (2011).

trade may be distributed unevenly amongst the sovereign and the people and between the people because of the use of violence in appropriating the product. The power game was not over with the demise of mercantilism, but continued to exert its impact. “Add to this”, he wrote, “ that, where the riches are in few hands, these must enjoy all the power, and will readily conspire to lay the whole burthen on the poor, and oppress them still farther, to the discouragement of all industry.” A highly uneven distribution of income is bad for society, its innovativeness and growth.

However, on the whole Hume was an optimist and counted upon an unintended by-product of trade. Trade, he argued, induces a process of the civilization of society. Trade is based on communication and helps to reduce prejudice, envy and hate. Those who trade, he famously opined, do not engage in wars – a bold view vis-à-vis the numerous conflicts waged with the force of arms the historian Hume was well aware of. In his optimism he went further and maintained that the commercial society improves morality and increases mutual trust amongst people, despite the fact that selfish and profit-oriented behaviour gained in importance. Hume was clearly one of the most fervent advocates of free trade and a deepening international division of labour and one of the greatest optimists as to socioeconomic progress this was expected to trigger. He strongly opposed the view that poor countries ought to fear rich neighbours. The opposite is true: rich neighbours are financially strong clients buying products from the poor country. Also their technological superiority is no reason of anxiety.

One can learn from them and imitate them, and in case the pressure of competition from their technologically much advanced firms is too strong, one may specialize differently, which is not so difficult in systems in the capital employed consists essentially of circulating or working capital and to a very small degree of fixed capital. It is important to keep the “spirit of industry flying”. Hume vigorously rejected the mercantilist view of foreign trade as a zero- sum game. No, he insisted, trade is positive sum game and, in principle, beneficial to all people involved. There may be some losers, but compared to the large number of winners they count for little and may easily be compensated from the huge gains that obtain.

Hume portrayed the economy essentially as a self-regulating system. The mercantilist fear that some economies, especially those that were not possessed of rich mines of gold and silver, such as England, could suffer from a plight of money was totally mistaken, because the “specie-flow mechanism” guaranteed a sufficient provision of the precious metals. If the domestically available quantity of money (specie: precious metals) was larger (smaller) than the quantity needed to keep the price level constant, then according to the *Quantity theory of money*, of which Hume was amongst the pioneers, prices will rise (fall). Now the trade balance of an open economy depends on the domestic money prices compared to the foreign prices. If many domestic prices are smaller (larger), a trade surplus (deficit) will result. This leads to an inflow (outflow) of specie at home (and vice versa abroad). The quantity of money in any one country is endogenous. If the quantity rises (falls), prices will rise (fall) and affect the competitiveness of firms, with the consequence that the trade deficit or surplus will shrink. The system is self-equilibrating. The mercantilist view that a country can only attract specie by promoting exports and curbing imports was wrong. In the long run national wealth is the result of high domestic productivity and the competitiveness of domestic industries and not of a policy of trade regulations and privileges.

4. Adam Smith on absolute costs and the division of labour

In his magnum opus An Inquiry into the Nature and Causes of the Wealth of Nations ([1776] 1976), Adam Smith (1723-1790) shared much of Hume's view on the matter, but not his excessive optimism, and added considerations that deserve to be mentioned. Hume had already argued that international specialization patterns are subject to absolute cost advantages, if no distortions interfere. Smith agreed and added that in conditions of free competition, defined as the absence of notable barriers to entry into and exit from markets, producers are compelled to cost minimize, because otherwise they will be driven out of the market. Costs of production include all material expenditures (means of production and means of subsistence) needed to overcome the "obstacles" (Ricardo) on the way to the wanted products. The deeper the division of labour within an economy and between economies, the larger is the productivity of labour. Since the division of labour is limited by the extent of the markets, free trade, by increasing the size of markets, is in principle productivity enhancing. Like Hume before him, Smith thus advocates a dynamic view of foreign trade and does not restrict his advocacy to static efficiency gains via a reallocation of labour and other productive resources across space: he focuses attention clearly on what nowadays are called dynamically increasing returns.

Smith bases his analysis also on an empirical anthropology concerned with man's properties (see Kurz 2015a). He speculates that there is "a certain propensity in human nature ... to truck, barter, and exchange one thing for another." (WN I.ii.1) He famously adds: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." (WN I.ii.2) Even the division of labour is rooted in this disposition to truck and barter: "As it is by treaty, by barter, and by purchase, that we obtain from one another the greater part of those mutual good offices which we stand in need of, so it is this same trucking disposition which originally gives occasion to the division of labour." (WN I.ii.3)

Smith's construction is therefore based on two crucial axioms: 1. The market is a natural form of organising economic affairs, because it reflects natural faculties of man. We might say man is a *homo mercans* or *homo negotians*. 2. Man's well-being depends on the proper exertion of his trucking disposition and thus on the functioning of markets, because they lead to an ever-deeper division of labour, increase labour productivity and raise income per capita, Smith's measure of the wealth of a nation.

The division of labour takes place first within firms between different workers (think of Smith's manufacturing of pins), then between firms, with some firms "outsourcing" certain activities, then between town and countryside and between different regions and eventually between different countries. Smith and his precursors were theorists of globalisation and the associated, always changing network of international specialization. He associated the following advantages with a deepening division of labour on a world scale: (a) gains from specialization, (b) a better utilization of labour and costly machinery, and, most importantly,

(c) *induced innovations*, the construction of *machines* that help to abridge labour and the gradual *mechanisation* of production (see also Kurz 2010).

The market works best and fairest, Smith was convinced, in conditions of free competition. Yet he was also aware of the fact that competition unleashes two kinds of forces: *centripetal* and *centrifugal* ones. Centripetal forces make market prices gravitate towards, or oscillate around, their "natural" levels, characterised by a uniform rate of profits on the capitals invested. There is thus a tendency towards what was later called a *long-period position* of the economic system. Centrifugal forces on the contrary challenge any such position in terms of innovations – new methods of production and new goods or better qualities of known goods. Technological and organisational change enforces the transition to new long-period positions with the new gradually replacing the old, typically following a sigmoid diffusion path.

In the first case the battle of competition is fought in terms of prices and cost of production, given technological and organisational knowledge. In the second case it is fought in terms of the generation and implementation of new knowledge –"improvements" or innovations. In this case competition may be compared to a whip that forces the economic system to reach higher and higher levels of productivity and commodity diversification. The process of socio-economic development is evolutionary. Competition means *rivalry* amongst agents and their economic behaviours. Political economy deals with a *dynamic system* of the production, distribution and use of the wealth of a nation. Domestic and foreign trade are but aspects of the system.

Certain Smithian ideas have been resumed in so-called "new" trade theory within a neoclassical analytical framework, championed amongst others by Paul Krugman (1995). He stressed that due to increasing returns to scale there are significant opportunities to trade between countries exhibiting similar levels of development (so-called "similar-similar trade"). Advantages inherent in specialization are amplified by large-scale production with increasing returns. Autarky equilibria can be shown to be socially inefficient in this case. However, some trade equilibria might be inefficient too or they might be no equilibrium. Yet on the whole, in his view, there is the clear presumption that trade is a good thing under increasing returns.

Increasing returns, he emphasized, typically reinforce, rather than call into question, the view that there are gains from trade.

5. Smith on the "wretched spirit of monopoly"

Smith advocated a system in which large parts of economic life are coordinated via interdependent markets in conditions of free competition. Such a system, he was convinced, favoured "equality, liberty and justice". He did not argue "that nothing but selfishness is necessary to yield socially beneficial outcomes". He encountered the dark sides of ruthless selfishness, greed and rapacity in the time in which he lived. He deplored especially "the wretched spirit of monopoly" that permeated the "mercantile system" with its privileges, preferences and concentration of power in a few hands. This system was beneficial to a few at the cost of the many and decelerated economic development.

Smith was aware that an innovator who introduced a new method of production into his business, which helped him to reduce unit costs of production, or who brought a new good to the market, which turned out to be highly wanted, could reap "extra profits" above and beyond the "natural" rate of profits obtained normally in the industry in which he was active.

Such "improvements", he understood well, gave rise to extraordinary benefits in terms of high rates of profit. But such benefits were typically not lasting, because competitors would imitate the successful innovator and eventually bid down prices until a competitive tendency towards a uniform rate of profits would make itself felt again.[6] From this case he distinguished sharply the case of a monopoly granted to, and protected by, the state. He insisted:

> The constant view of such companies is always to raise the rate of their own profit as high as they can; to keep the market, both for the goods which they export, and for those which they import, as much understocked as they can: which can be done only by restraining the competition, or by discouraging new adventurers from entering into the trade. (WN V.i.e.10)

Such monopolies could not be contested by competitors and therefore had all the rights and opportunities to exploit their privileged position as much as they could. The most important cases were trading monopolies, such as the English East India Company. Smith stated:

> Some nations have given up the whole commerce of their colonies to an exclusive company, of whom the colonists were obliged to buy all such European goods as they wanted, and to whom they were obliged to sell the whole of their own surplus produce. It was the interest of the company, therefore, not only to sell the former as dear, and to buy the latter as cheap as possible, but to buy no more of the latter, even at this low price, than what they could dispose of for a very high price in Europe. It was their interest, not only to degrade in all cases the value of the surplus produce of the colony, but in many cases to discourage and keep down the natural increase of its quantity. Of all the expedients that can well be contrived to stunt the natural growth of a new colony, that of an exclusive company is undoubtedly the most effectual. (WN IV.vii.b.22)

Such companies, Smith was convinced, were bad for their home countries, but a disaster for the foreign countries. The rule of such companies in colonies, he explained, was typically violent and cruel. And he was aware of the role of cultural differences between countries such as England and India. Merchants assuming the role of political leaders in a country in which "vaishyas" did not occupy a leading social position of necessity asked for trouble. A fervent advocate of free trade, Smith deplored "the savage injustice of the Europeans [who] rendered an event, which ought to have been beneficial to all, ruinous and destructive to several of those unfortunate countries." (WN IV.i.32)

Let us listen to two voices from India what happened. The famous judge, Sanskrit scholar and translator of the *Bhagavad Gita* into English, Kashinath Trimbak Telang (1850-1893), opposed the reactionary rule of Lord Lytton as Viceroy in India, sent by the Disraeli government. In a number of papers published in the second half of the 1870s he criticised the British free trade argument, because it ignored the inequality of power between what was euphemistically called the "motherland" and the colony (see also Corbin and Perry 2019). The author endorsed Friedrich List's doctrine (1841) and advocated a pragmatic approach of protection and trade

[6] Smith allowed for persistent differentials of profit rates in a number of cases, which we put on one side here; see therefore the discussion in Kurz and Salvadori (1997: chap. 11).

and the establishment of a national system of innovation. Protection of emerging domestic industries was badly needed vis-à-vis the technologically far superior competitors.

Dadabhai Naoroji (1825-1917), the Parsi scholar and eminent Indian politician, in a book published in 1901 and significantly titled *Poverty and Un-British Rule in India* accused the British of teaching free trade, the rule of law and the separation of political power and wealth, but practised precisely the opposite. He rightly pointed out that

> As the drain prevents India from making any capital, the British by bringing back the capital which they have drained from India itself, secure almost a monopoly of all trade and important industries, and thereby further exploit and drain India, the source of the evil being the official drain. (1901: 38)

6. David Ricardo and the principle of comparative advantage

Ricardo's principle of comparative advantage has frequently been misapprehended. This is partly due to the fact that Ricardo's friend James Mill and his son John Stuart put forward erroneous interpretations that had a lasting impact on the reception of Ricardo's doctrine (see Sraffa 1930). At the same time it has to be admitted that Chapter VII, "On Foreign Trade", of the Principles (1817) involves a formidable challenge to the reader, because in it all major threads of which the fabric of Ricardo's analysis consists coalesce and all problems pertinent to the theme under consideration are present in just a few pages. Is there a plain man's guide to Ricardo's view on foreign trade? I believe there is. (For the following, see Kurz 2015b and 2017.)

Many interpreters of the principle of comparative advantage have overlooked the fact that in Ricardo's reasoning merchants and money play curcial roles. Abstracting from them is a source of dire confusion and misunderstanding. However, neglecting the role of money might perhaps be taken to be suggested by the numerical example by means of which Ricardo illustrates the principle at work, his "magic four numbers" (see *Works* I: 135–136), as Paul Samuelson called them. See the tabulation in Table 1.1.

Table 1.1 Ricardo's four 'magic' numbers

Number of men whose labour is required for one year in order to produce a given quantity of	*Cloth*	*Wine*
In Portugal	9 0	80
In England	100	120

From this example Ricardo draws the conclusion that it would be advantageous for England to export cloth in exchange for wine imported from Portugal, and for Portugal to export wine in exchange for cloth from England. In this way "England would give the produce of the labour of 100 men, for the produce of the labour of 80" (*Works* I: 135). So where is money, where are self-seeking agents?

The following remarks are in place. First, there is no presumption that cloth and wine are the only commodities produced or consumed in the two countries. Secondly, there is no presumption that the trading parties are countries rather than merchants, and that their concern is with amounts of labour and employment rather than monetary profits and prices. The example illustrates only the macro outcome of the micro actions of self-interested agents, especially merchants, to which we now turn. We distinguish between two monetary regimes also mentioned by Ricardo: (i) the case of two non- convertible currencies and (ii) trade under the gold standard.

In case (i), assume that in Portugal there is the Portuguese Real (*R*) and in England the Pound (*£*). With relative domestic prices being proportional to the relative quantities of labour bestowed upon commodities, as Ricardo argued in the chapter "On Value", the money prices of the amounts of cloth and wine in the two countries are proportional to the quantities of labour spent in producing them. In this case the numbers in Table 1.1 may now seen to represent Reals or Pounds respectively.

Ricardo was a highly successful stock jobber and surely has quickly seen *arbitrage* opportunities implied by the different *relative* domestic prices of cloth and wine waiting for merchants of the two countries to be exploited. An English merchant, for example, may buy for 100 *£* a given quantity of cloth at home, ship it to Portugal and sell it there for 90 *R*. With this sum of money he may then buy 9/8 units of wine from a Portuguese wine grower, a unit costing 80 *R*. This quantity of wine he may then ship to England, where he sells it for (9/8) 120 *£* = 135 *£*. He thus yields a profit of 35 *£*, which amounts to a rate of profit of 35 per cent on an investment of 100 *£* over the time it took to carry out his business, that is, export cloth and import wine. (We ignore transportation cost and the like.) Similarly a Portuguese merchant who may buy for 80 *R* wine, ship it to England, sell it there for 120 *£* and buy for this sum 6/5 units of cloth. This he then ships to Portugal and sells it for (6/5) 90 *R* = 108 *R*. He thus yields a profit of 28 *R* or a rate of profit of 35 per cent on an investment of 80 *R*.

In this perspective, the comparative cost doctrine expresses simply the principle of arbitrage. It illustrates the mercantilist motto "to buy cheap and to sell dear"; the principle was known in the business world for a long time. Ricardo at any rate does not appear to have thought that he had made a huge discovery. The remarkable fact in the example given is that while goods are exported and imported, the currencies of the two countries do not cross borders. As Ricardo stressed with regard to a somewhat different, but comparable case: "without the necessity of money passing from either country, the exporters in each country will be paid for their goods" (*Works* I: 138).

When relative domestic prices in England and Portugal change, arbitrage opportunities, and thus merchants' profits, change too. Relative prices are bound to change, because there are non-constant returns to scale in the two sectors of the economies under consideration – the growing of wine and the fabrication of cloth. Wine is a product of agriculture, which is subject to diminishing returns. Cloth, on the contrary, is a product of manufacturing, which according to Adam Smith is subject to what nowadays are called dynamically increasing returns. An aspect of Smith's respective argument is the invention of improved machines, which he considers to result from and at the same time to propel forward the division of labour in a kind of *circulus virtuosus* (cf. Smith, WN I.i.8). Ricardo approved of Smith's respective argument which can be seen when he discusses forces counteracting a fall in the general rate of profits due to diminishing returns in agriculture. He draws the attention to "the improvements in machinery, by the better division and distribution of labour, and by the increasing skill, both in science and art, of the producers" (*Works* I: 94). An increase in the production of wine in Portugal can therefore be expected to increase costs (i.e. labour) per unit of wine output in Portugal, whereas an increase in the production of cloth in England can be expected to reduce costs (i.e. labour) per unit of cloth output in England. The former effect tends to diminish Portugal's comparative advantage, while the latter tends to increase England's. Clearly, the technical conditions of production in the two sectors of the two countries and their output levels are interdependent, with trade flows between the two countries leading to changing expressions of the principle of comparative advantage. The speed at which such changes occur depends, inter alia, on the growth of the two economies, which itself depends on the factors just mentioned and the dynamics of real wages. These considerations obviously apply *cum grano salis* to the case in which forms of technical progress other than those associated with an ever-deeper division of labour contribute to shaping the development of the economies under consideration.

As regards second, third and so on round effects of the impact of trade on an economy's development and changing pattern of specialization, Ricardo provided only a few general hints. He confined his investigation to an explanation of the working of the principle of comparative advantage for a given state of affairs. But he had laid the groundwork for an analysis of the dynamics of two interdependent economic systems subject to non-constant returns in the various sectors of the economy and different forms of technical progress.[7] He was also clear that little could be known about the precise shape of returns, future technological progress and the movement of real wages and so on.

Next we turn briefly to the case in which the gold standard applies. The total amount of gold in the world economy comprising only Portugal and England is given and fixed. The four numbers now express the gold prices of given quantities of cloth and wine in autarky in Portugal and England. Both commodities are more expensive in England; therefore Portugal has an absolute advantage with regard to both. Hence goods will be shipped from Portugal to England. In the limit, English producers stop producing both commodities and Portuguese producers meet effectual demands of them in both countries, which, however, is improbable given diminishing returns in wine production. Portugal would have a trade surplus and England a trade deficit, with the consequence that specie (gold) would flow from England to Portugal. The quantity of money in Portugal would thus increase and, according to the quantity theory of money, a version of which Ricardo elaborated, money prices would rise in Portugal and fall in England.[8] Foreign trade would affect prices and the value of money in the two countries. In a different context Ricardo puts forward a proposition, invoking the specie-flow mechanism; a slight modification of his proposition renders it applicable to our case: "But the diminution of money in one country, and its increase in another, do not operate on the price of one commodity only, but on the prices of all, and therefore the price of wine and cloth will be both

[7] In his *Graz Schumpeter Lectures*, Neri Salvadori (2019) elaborated on some of Ricardo's ideas and put forward a fascinating analysis of economic development of two economies tied together via foreign trade.
[8] It does so quite independently of non-constant returns to scale in both lines of production, which for simplicity we put on one side in the above reasoning.

raised in [Portugal], and both lowered in [England].” (*Works* I: 139–140) The opposite movements of prices in the two

countries gradually undermine Portugal’s absolute cost advantages in both lines of production.

The lop-sided pattern of trade turns out to be unsustainable. The diminution of money in England and its accumulation in Portugal will bring about “such a state of prices”, Ricardo insists, “as would make it no longer profitable to continue these transactions” (*Works* I: 139). As soon as the gold price of one of the commodities produced in England has fallen below the gold price charged in Portugal, trade will be reversed: now England has an absolute cost advantage and will start exporting the product instead of importing it. Which product will that be? On the assumption that relative prices of the two products in the two countries will not be affected by changes in absolute prices, it will be the product in which England had a comparative advantage in the initial situation, which now has turned into an absolute advantage. Trade and the involved redistribution of specie on a world scale takes to the fore the working of the principle of comparative advantage by means of changes in absolute costs.

As regards Ricardo’s Smithian point of view concerning privileges and monopoly positions given to trading companies, see his speeches at the General Court of the East India Company (*Works* V: 478-483).

7. Friedrich List – a critic of the free trade doctrine

In his book Das Nationale System der Politischen Ökonomie (The National System of Political Economy), first published in 1841, the German economist Friedrich List (1789- 1846), representative of the older German Historical School, was critical of Smith’s cosmopolitan outlook and the doctrine of free trade that is congenial to it. Under the influence of one of the authors of The Federalist Papers and founding father of the United States of America, Alexander Hamilton, List developed his infant industry argument and paved the way to a recurrent tenet of the German Historical School: each nation had special requirements according to its particular circumstances and the attained level of development. List warned sarcastically of the teachings of the free traders:

> Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than to throw away these ladders of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in the paths of error, and has now for the first time succeeded in discovering the truth.

He was convinced that his was precisely what the British free traders did. He added:

> The result of a general free trade would not be a universal republic, but, on the contrary, a universal subjection of the less advanced nations to the predominant manufacturing, commercial and naval power, is a conclusion for which the reasons are very strong.

As against this destiny, he insisted, only a judicious policy of protection coupled with an industrial and educational policy would help:

> The system of protection, inasmuch as it forms the only means of placing those nations which are far behind in civilisation on equal terms with the one predominating nation, appears to be the most efficient means of furthering the final union of nations, and hence also of promoting true freedom of trade.

Hence, in his view free trade could not be the starting point, but only the terminal point of a "union of nations". At first the source of a nation's true wealth had to be developed, which required the development of its productive powers. Otherwise it would run the risk of becoming easy prey for its superior competitors. Contrary to Smith, List thus argued that the private interests of individuals must be subordinated to the maintenance, completion and strengthening of the nation. List's teachings fell on fertile ground in many less developed countries, including India and China.

8. Concluding remarks

The classical economists and especially Ricardo have deepened our understanding of the causes and possible effects of international trade. Adam Smith and then David Ricardo, who agreed with the Scotsman whenever he did not say explicitly otherwise, did not unconditionally support free trade. A fervent critic of the East India Company, which in his view was the worst example of what the "wretched spirit of monopoly" could bring about, Smith asked for the establishment and preservation of free competition amongst trading partners. Privileges granted to some firms or parties were detrimental to the interests of the others and ought to be abolished. Free trade, these authors were convinced, was beneficial to all sides, provided it was truly *free*, that is, not contaminated by an asymmetric distribution of political and economic power. Considerable differences in technical and managerial know-how between domestic and foreign producers they did not really consider to be problematic, because with a relatively low fixed capital and a relatively low human capital intensity, and thus low sunk costs in most industries, a redirection of production and change in the pattern of specialization was comparatively easy. Costs of transition in response to the different competitiveness of domestic and foreign firms were relatively low and the specie-flow mechanism system guaranteed a relatively smooth adjustment process. And while the classical authors showed some awareness of the possibility of one country becoming economically dominated by another one through the channels of trade they were optimistic that that this danger was small. It was Friedrich List, who questioned this optimism. He proposed to protect infant industries until they had become competitive and to develop the productive powers of a nation by means of an education and industrial policy. He may thus be called an advocate of a *mixed economy* with a strong public sector that is intimately involved in a social division of labour with the private sector.

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