

Paul Krugman owes much of his considerable reputation as an economic theorist to “new trade theory.” In contrast to traditional trade theory, supporters of the new view deny that free trade is always advantageous: the exceptions largely concern cases of “increasing returns.” “It’s obvious that the new trade theory introduces the possibility that government action can, in effect, *create* comparative advantage” (p. 110). Government action does this, one gathers, by promoting large-scale production in industries where increasing returns obtain. In pursuit of this end, tariffs may be a useful tool; such is the new wisdom of “strategic trade policy.”

Krugman does not renounce the new theory—far from it. With forthright immodesty, he declares the new “sophisticated” theory, of which he was a principal developer, “part of the mainstream of economic analysis” (p. 109). But he dislikes intensely the use that has been made of the new theory by writers he damns as incompetent and economically illiterate.

The writers who arouse our author’s ire include Robert Reich, currently Secretary of Labor, and the MIT economist Lester Thurow. They wrongly think of international trade as if it were a “zero-sum” game, to use a phrase from the title of a best-selling book by Thurow. In this view, one party’s gain in trade is another’s loss. Trade becomes an instrument of economic warfare.

In fact, of course, the situation is quite otherwise. Trade does not take place unless both parties expect to benefit from it; unlike war, the gain to one party does not depend on the loss of another. Further, trade can still be advantageous even if one country is, in all goods traded, inferior in productivity to its trading partner. As David Ricardo long ago demonstrated, “a country will always find a range of goods in which it has a ‘comparative advantage’” (p. 91).

Proponents of strategic trade make a great deal of fuss about the supposed need for international “competitiveness.” This elusive concept appears to consist, in large part, of a nation’s having a “favorable” balance of trade. Krugman isn’t buying: “Both in theory and practice a trade surplus may be a sign of national weakness, a deficit a sign of strength” (p. 6). Contrary to widespread belief, deteriorating terms of trade have not been “a major drag on the U.S. standard of living” (p. 8).

Wherein lies the fundamental fallacy of the strategic traders? They think of nations as if they were rival firms in competition for a market. But "countries do not compete with each other the way corporations do . . . the major industrial countries, while they sell products that compete with each other, are also each other's main export markets and each other's main suppliers of useful imports" (p. 9). International trade should not be viewed, in a parody of Clausewitz, as "the continuation of war by other means," our new traders to the contrary notwithstanding.

Krugman's case may in one respect elicit surprise. As he himself is at pains to stress, he is saying nothing new. He merely restates and reiterates commonplaces of economic analysis. Here precisely arises the element of surprise. Why do such elementary points require restatement in this day and age? Surely authors of the stature of Reich have already taken account of them.

In fact they have not. Krugman mercilessly exposes many supposed eminences as ignoramuses of the first order. He comments, for example, on a passage on international trade by the Yale historian Paul Kennedy as follows: "did you find the quotation from Professor Kennedy hysterically funny. . . . Kennedy feels that he is in a position to discuss the idea of comparative advantage . . . *without understanding the idea*" (p. 86). Readers will discover that this hapless historian is but one of many offenders.

Students of Austrian theory will be reminded of a case that closely resembles the situation Krugman has depicted. After Mises argued that economic calculation under socialism is impossible, sophisticated economists, notably Oskar Lange and Abba Lerner, devised models of so-called market socialism which, they claimed, *could* accomplish the task of calculation.

In my view, Mises and Hayek more than adequately dispatched these models. But, regardless of how one judges the dispute, there is another point that demands attention; and here is where the parallel with Krugman's case arises. The Lange-Lerner models were abstractions that bore no relation to actually existing socialist economics. Even if correct, they would have no bearing on the question, can socialism in the actual world solve the calculation problem?

Nevertheless, socialists acted as if the mere existence of these models sufficed to dispose of the calculation problem. In like manner, the strategic traders take the very limited claims of the new trade theory to have demolished altogether the basic Ricardian case for free trade. The plans of Reich and company are not correctly derived from the new theory. Nevertheless the mere existence of the new account somehow is supposed to redound to their benefit.

Readers who do not like loose ends may be inclined to raise a further point. Just as the Lange-Lerner models do not succeed in answering Mises (or so

Austrians would claim), is there likewise a fallacy in the arguments of Krugman and his fellow new traders that the case for free trade is in theory flawed?

To answer this far exceeds my competence; and Krugman's devastating ripostes should be sufficient warning against any temptation to stray across disciplinary boundaries. But I shall venture one remark about the normative implications of the new theory, which our author acknowledges "are much more controversial" (p. 110) than the descriptive part of the theory. Krugman informs us that "clever government intervention cannot only shift the pattern of comparative advantage, but also do so in a way that raises the intervening country's real income at the expense of other countries" (p. 110). Those who have taken their Mises and Rothbard to heart may wonder why "a country's real income" has any place at all in a sound welfare economics.

Throughout his book, Krugman has been concerned to assert the prerogatives of economic theory. Those not expert in these deep matters should not presume to comment on them. Our author's claim to authority rests on indisputable credentials; but at one point, I venture to suggest, he has gone beyond his area of specialized knowledge.

In defense of the Nafta Agreement, Krugman admits that Nafta supporters "considerably glamorize the reality" of the treaty's supposed economic benefits. In fact "NAFTA will . . . produce only a small gain in overall U.S. real income" (p. 157).

Why, then, does Krugman wax enthusiastic over the arrangement? For him, Nafta is primarily a foreign policy issue; it is needed to promote the stability of the Mexican government. "For the United States, this agreement is not about jobs. It is not even about economic efficiency and growth. It is about doing what one can to help a friendly government succeed" (p. 165). If Krugman is right about Nafta's lack of economic impact, then he exits the scene as an expert on the treaty's merits. *Prima facie*, his opinions on foreign policy merit no more consideration than those of any other layman. Those less inclined than our author to view the Salinas government as a fit object of idolatry need here pay him no heed.

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