Geoffrey E. Wood
Second edition

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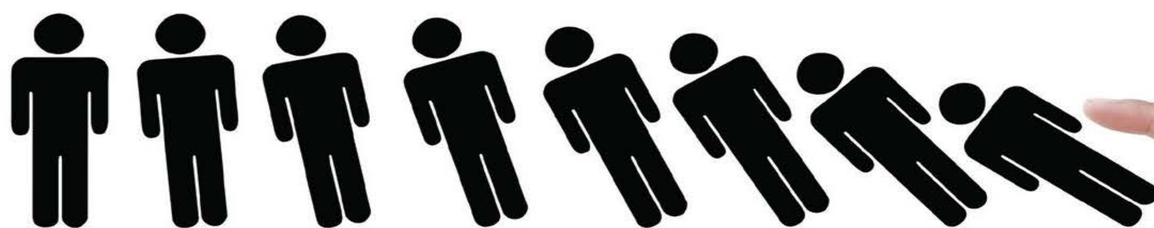
Fifty Economic Fallacies Exposed



Second edition published in Great Britain in 2014 by
The Institute of Economic Affairs
2 Lord North Street
Westminster
London SW1P 3LB
in association with London Publishing Partnership Ltd
www.londonpublishingpartnership.co.uk

First edition published in 2002 by
The Institute of Economic Affairs
in association with Profile Books Ltd

The mission of the Institute of Economic Affairs is to improve understanding of the fundamental institutions of a free society by analysing and expounding the role of markets in solving economic and social problems.

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A CIP catalogue record for this book is available from the British Library.

ISBN 978-0-255-36665-6 (ebk)

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Typeset in Kepler by T&T Productions Ltd
www.tandtproductions.com

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FOREWORD

It is often said that economics is applied common sense. Unfortunately, as I remember the man wh
owned the local bicycle shop saying to me when I was a child, 'the problem with common sense is th
it is not common enough'. And so it is that the demand for this monograph by Geoffrey Wood, *Fif
Economic Fallacies Exposed*, never seems to decrease.

I was delighted that Professor Wood agreed to update this publication to allow the IEA to publish
new edition. A few old fallacies have been removed to make room for new ones (though, no doubt, th
old ones will become relevant again in the future). But, as the author said to me, all the fallacies a
essentially the same. They arise from an inability of people to understand supply and demand (and, b
implication, opportunity cost).

Henry Simons once said: 'Economics is primarily useful, both to the student and to the politic
leader, as a prophylactic against popular fallacies.' Through the vehicle of undermining fallacie
Professor Wood brings to his audience good economics. As such, this new edition of *Fifty Econom
Fallacies Exposed* is an important contribution to the IEA's educational mission.

The views expressed in this monograph are, as in all IEA publications, those of the author and n
those of the Institute (which has no corporate view), its managing trustees, Academic Advisor
Council members or senior staff. With some exceptions, such as with the publication of lectures, a
IEA monographs are blind peer-reviewed by at least two academics or researchers who are experts
the field.

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July 20

ACKNOWLEDGEMENTS

I am indebted to the late Arthur Seldon, who was Editor of *Economic Affairs* when I first proposed regular feature exposing economic fallacies, both for accepting my suggestion and for his ever usef editorial advice. Second, many thanks go to his successor, Colin Robinson, for continuing the featu and for his most helpful suggestions of fallacies to expose and of improvements to what I had writte Third, my colleague Forrest Capie deserves thanks for over the years drawing to my attention a goo number of fallacies to discuss, and giving very useful comments on drafts. Fourth, and mo important, my thanks go to my assistant Debra Durston. Mrs Durston worked with me for over 2 years with continual efficiency and unshakable good humour. Her contribution to all my work over th years has been considerable. I am particularly glad to be able to acknowledge it here, in a book which, by her calmness under pressure, she has contributed so much.

Thanks are also due to Joe Little, of the University of Bristol, who helped with the selection fallacies to be included in this revised edition.

INTRODUCTION

Each of the short essays in this volume comprises the application of basic economic analysis and log to a frequently repeated but fallacious belief about one aspect or another of the economy. Occasion reference is made to an item of data, but that is always simply to illustrate a point; the argument nev depends on data, but always on logic.

The essays aim to serve two purposes – to illustrate aspects of economic reasoning, and to expo wrong, occasionally counterproductively or even dangerously wrong, arguments. The topics are drav from both micro-economics and macro-economics. But in every case the reasoning applied to them either explicitly micro-economic or clearly derived from micro-economics. This reflects the fact th micro-economics, the analysis of firms and individuals interacting in markets, is the basis of *a* economic analysis.

TICKET TOUTS ARE HARMFUL AND WICKED. THEY SHOULD BE STAMPED OUT BY LAW

There is an idea about that being a ticket tout is in some unexplained way disreputable, and that tho who deal with them, whether buying or selling, are disgracing themselves and their associates. Or cannot refute a moral judgement by logic. It is not a matter of economics. But what economics can d is to show that ticket touts are useful, and that they provide a service to both seller and buyer. There absolutely no case for making their activities illegal.

To see this, think about what a ticket tout does. And just for the moment, we shall not call what h trades in ‘tickets’ – we shall call them ‘the item’.

Some person has a supply of the item surplus to what he wants. The item does not keep for ever indeed, after a certain date it becomes useless. He can do several things with it – give it away, not us it (and thus let it go to waste), or he can sell it. If he wants to sell it, there are many methods open him; but a very convenient one is to find someone who deals in the item, and is willing to buy it wi the aim of reselling it, but bearing the risk that he may fail. The original possessor of the item, who not a professional dealer, is willing to sell for a little less than he might receive from the fin consumer in return for someone else bearing the risk of not selling the item.

The intermediary now has a stock of them, which he tries to sell. He tries to sell at a price high than he paid, to people who want to buy it.

Now consider the whole transaction. One person had some items surplus to his wants. He sells the to someone who then tries to sell them to a person who does want to use them. No one has bee harmed by the chain of transactions – and that is fortunate, for there are millions of such transactio every day. A newsagent buys newspapers and sells them on. A grocer buys food and sells it on. A dealer in government securities buys them and sells them on. We don’t attach the discreditable nam of ‘tout’ to newsagents, grocers and bond dealers and say their activities should be made illegal. Wh do we do it to dealers in tickets?

If we banned ticket touts, we would be making both buyers and sellers worse off. And by makin illegal a harmless activity which benefits all who take part in it, it would divert police effort awa from dealing with real crime. The idea that ticket touts should be banned is nonsense.

June 198

THE CONDUCT OF AN INDUSTRY – IN PARTICULAR, HOW IT SERVES CONSUMERS – IS IMPROVED BY GOVERNMENT REGULATION

It is widely believed that government intervention in industry can and does benefit consumer Economists have developed careful and clear analyses of the situations when regulation could b desirable. But does regulation in practice have these desirable effects?

Adam Smith certainly doubted its efficiency. To restrain people from entering into voluntar transactions 'Is a manifest violation of that natural liberty which it is the proper business of law not infringe but to support'. Nevertheless, he argued, 'those exertions of the natural liberty of a fe individuals which might endanger the security of the whole society, are, and ought to be, restrained b the laws of all governments…' He defended regulation in such cases in principle. But he objected the practice. The legislature, he argued, is directed not by a view of the common good, but 'th clamorous importunity of special interests'. His view was that whatever regulation could do in theor in practice it usually benefits those regulated.

What does the evidence say? A pioneer in this area was George Stigler. In a study of the electricit industry in the US, he found that regulation affected neither rates charged to customers nor profi earned for shareholders. In a study of the securities industry, he found that regulation governing th listing of new securities, presumably intended to protect the investor, had no significant effect on th returns to new shares as compared to ones already in the market.

A current UK example which should lead one to wonder about the benefits of regulation is foo When it was feared that eggs were likely to be harmful, and sales dropped, egg farmers were offere compensation – which was paid of course by a levy on consumers, who had just very plainly indicate in the market that they did not wish to support egg farmers! In contrast, how was a different grou one not close or important to the regulators, treated? Producers of non-pasteurised cheeses – a tin group of farmers – and foreign cheese makers, were both threatened with having their products banne on health grounds before consumers had a chance to show if they were concerned!

Regulation has two vices. It restricts competition – all producers are compelled to behave in similar way. And it restricts information – information has to go to the regulator, but not to th consumers who buy the product. Informed choice is not possible without information; and restrictin competition means that there is less pressure to raise quality and lower cost. For these reason regulation by government generally harms the consumer. The best regulation is by competitio combined with provision of information.

August 198

There is now widespread popular concern about the ‘quality of life’ and the environment. Both a said to be deteriorating and, it is claimed, this can be stopped only by the state preventing destructiv private actions which have no regard for the consequences for people. We need, it is said, planning t protect the world.

This is in many cases the opposite of the truth. It is state action that is the destroyer, private th preserver.

Two examples are useful. Consider the proposed High Speed 2 rail link. Even in its revised form th will be destructive of how people want to live. That is not a private action. It is the result of the sta giving a body – High Speed 2 Ltd – the right to dispossess people of something at a price below th which would induce them to move voluntarily.

Town planning is another example. Buildings can be put up when permission is given – regardless o the wishes of those who live nearby – at the whim of a civil servant or the vote-catching urge of politician.[1]

Both these problems arise because politicians either take away property rights or refuse acknowledge their existence. If people have rights in property – if they own it – they will preserve it.

Consider the above two examples. If people had to be paid to leave their homes or tolerate a tra near their garden, the costs to society of building the rail link would be taken into account. If owne of houses were entitled to compensation for a hideous new building increasing congestion aroun them, again the cost of the building would be taken into full account.

This would produce efficient resource allocation; costs would be taken fully into account. And would also produce the desired amount of preservation. Not, no doubt, everyone’s desired amount too much for some, too little for others. But it would produce what people were willing to pay for.

Acknowledging property rights in the environment would thus serve two purposes. More efficie resource allocation would take place. And the present debate about preserving the environment woul be clarified. At the moment people call for preservation unthinkingly because the costs do not fall o them. If the cost of resisting a development was not being paid a large sum in compensation, then th objectors would think. As it is, they might as well resist.

Acknowledging property rights in the environment would preserve what people want. N acknowledging these rights, having state planning, leaves the present and future environment up to th accidents of election timing and chance.

December 198

(Updated April 201

1 A colleague of mine has been sufficiently unfortunate to suffer both types of damage. Present HS2 plans threaten the foundatio
of his house, and a building two streets away has blocked a fine view from his study.

There seems to be an idea about that firms should not make profits. Railway companies are criticis
for making profits. That a company which aimed not to make profits did not win the first franchise
run Britain's national lottery was thought by some to be undesirable, even disgraceful. Utili
companies are condemned for making profits. But all this barrage of criticism is based on
fundamental misunderstanding; profits are a useful, indeed essential, part of an economy.

To see this, start with the example of a hypothetical firm. This firm makes and sells a good, sho
say. To make these goods it needs workers, leather and machines. And all three have to be paid fo
The workers need to be paid their wages, salaries and benefits. The suppliers of leather have to be pa
or they will take their cows elsewhere. And what about the machines? They do not have to be paid. B
they did have to be bought, and, when they wear out, they will have to be replaced if the firm wishes
continue in business.

The firm could get the money to buy the machines in one of two ways (or a combination of them).
could borrow the money, or it could spend money that it had earned and saved in the past. If th
money is borrowed, the lenders need to be paid. And if the firm uses its own funds, it is giving up th
chance of lending the money to someone else. So either way, a return on the investment should b
earned. True, it could fail to earn a return. Then, if the firm had borrowed the money, the firm woul
be closed down by its creditors trying to get back what they had lent, so it would not continue
operation. If it had used its own funds it would not face that risk; but, when the machinery wore ou
the firm would not be able to continue in business without getting funds from someone else, for
would not have been earning anything to set aside for the future.

Now, what is that part of the firm's earnings that goes to pay for its capital? The answer is, profi
Profit, in other words, is a part of firms' costs just as wages are. Profits, like wages, are earning
which are essential for producing the firm's output.

Now, some organisations really do survive without making profits. The Institute of Econom
Affairs is one. Like all such organisations the IEA depends on gifts. In the IEA's case, these gif
cover not just the capital costs, but a good portion of other costs, as well, but that is beside the ma
point. Organisations which choose not to make profits can and do survive, but they depend on th
receipt of gifts.

At the other extreme, there are firms which are claimed to make 'excess profits'. One might think
'excess profits' as being a rate of profit greater than necessary to keep the firm and its capital sto
going year after year. Now, that has to be complicated a bit. If a firm is producing something fo
which there is unexpectedly strong demand, then it could earn 'excess profits' in the above sense for
time, until either the firm had expanded or other firms had entered the same line of business.

In general, 'excess profits' are eliminated by one of these routes, and are purely a transitor
phenomenon, unless there is absence of competitive pressures, so that there is neither new entry, no
pressure to expand so as to prevent new entry, to the industry.

The main case in which 'excess profits' can be sustained is when government prevents other firm
entering – when it creates a monopoly. Sometimes it regulates monopolies it has not created; and the
its objective is to ensure that the excess profits are eliminated. But not, it is essential to emphasise,
eliminate the profits. If it did the latter, it would quickly eliminate the firm.

It is now almost possible to conclude. But before doing so, it is useful to touch on organisatio

which are ‘not-for-profit’. Such organisations can have a wide range of objectives, and can take a wi
~~range of forms. Some are, like the IEA, run as charities, and supported primarily by donations~~. Th
supply something regardless of whether it is paid for. Other organisations may cover their costs, b
do not necessarily behave in other ways like profit-making firms. They may, for example, not rais
their prices if there is excess demand for their goods. This does, of course, mean that they cannot rai
the funds to allow them to expand so as to satisfy this demand, but presumably they have some oth
objective. But even in this case, they have to cover the costs of their capital, or they go out
business. They do earn profits. They do not, however, respond to the signals to expand (or contrac
that changes in profits provide.

To conclude, profits play an essential part in economic life. They represent the return on a firm
capital. Organisations can be ‘not for profit’. In that case, they are either charities (whether in th
strict legal sense or not) or earn profits but are not guided by them so as to vary the scale of the
output. Apart from charities, it makes no more sense for a firm not to earn profits than it does for
not to pay its workers’ wages.

In short, the current fashionable love of ‘non-profit’ firms is based on not understanding the natu
and importance of profits. One can only hope the fad does not persist.

December 20

ONE COUNTRY SHOULD NOT CUT ITS TARIFFS UNLESS OTHERS DO

A common claim is that tariff reduction, perhaps even to the extent of moving to completely fr trade, has to be reciprocal. One country it is said should not on its own adopt free trade. Son proponents of this recognise that unilateral free trade is beneficial, but use the promise of tari reduction as a bargaining device to get other countries to reduce their tariffs. Some people claim th unilateral free trade is harmful. That is a fallacy, and one which can be very damaging.

If a country has no tariff barriers (or other barriers to international trade) it benefits in two ways. benefits in consumption and it benefits in production.

The consumption benefits are the most obvious. Consumers can buy what they want wherever it produced most cheaply, whether it is at home or abroad. There are not tariffs to make home-produce goods artificially cheap compared to those produced overseas; or, perhaps, to divert demand from th cheapest foreign supplier to one who, although more expensive, has from political favour won a low tariff against his goods.

Consumers, in summary, can make the most of their income if they live in a country with r impediments to international trade. But of course consumers either are or depend on producers – to g the income they consume. Could free trade harm producers? The answer is that it could – and probab would harm some. But the economy as a whole would still gain. The reason is as follows. Produce are guided by the prices they see confronting them to produce what is most profitable for them and do so as cheaply as they can. Prices thus direct resources to where they are most useful, as tho producers to whom they are most valuable will pay most for them. If an economy is trading freel without tariffs, its resources are making the most of the opportunities prescribed to them by th pattern of prices in the rest of the world.

The economy's resources will thus be used where it is most productive, relative to the rest of th world, for them to be. The economy will be making the most of the opportunities available to (These opportunities would of course be greater if all the world were a free trade area, but that is n really something any one country can produce.)

It is possible to construct a theoretical example where a country gains benefit by imposing tariffs, these shift prices in its favour. But this example depends on the implausible assumption of gre monopoly power and other countries not objecting and retaliating.

In summary, free trade is the best course a country can follow. Any other course impoverishes th country – by making production inefficient and denying consumers access to the cheapest market Protection is totally unjustifiable.

November 19

Visiting the United States, one is struck by a particular aspect of the discussions of free internation trade. The USA is moving towards a North American Free Trade Agreement (NAFTA) which aims, i principle, to remove all government-created trade barriers to the movement of goods between th countries of that area – Canada, the USA, and Mexico. But a major hindrance has emerged environmental standards in Mexico.

It is not clear whether those who raise this difficulty are concerned about the environment, concerned just to maintain protectionism. For now, let us give them the benefit of the doubt. Let u assume that they really believe that efficient international trade requires the same environment standards of every country which engages in it. That fallacy is the one exposed in this column.

Why do countries engage in international trade? One obvious reason residents of one country bu goods from residents of another is that they cannot be produced at home. By far the greatest part international trade is trade which takes place because some goods can be produced better or mo cheaply (or both) in one country rather than in another.

What produces these price differences? (I focus on price differences henceforth as they are what is issue.) Climate is one factor. Another, very important, is relative abundance of resources, makin some cheaper in one country than in another. Note that it is relative abundance in two senses – in on country as compared to another, and abundance produced by ample supply *relative to demand*. F prices to be low, there needs to be an abundant supply of a good relative to the demand for it. The being a lot of the good, or a little, in the physical sense does not give any information about price.

Now to NAFTA and environmental standards, where the above discussion will help clarify matter and expose the fallacy. Mexico can produce some goods more cheaply than the USA for a variety o reasons. Among these reasons, and particularly important for some heavy industries, is th manufacturers in Mexico do not have to meet the same low-pollution standards. Their 'smoke-stac industries' still have smoke stacks!

Why is this, and what would be the consequences of insisting that it be stopped before Mexico w allowed to export to the USA without any restrictions?

There are many reasons. Tastes vary. Smoke may be seen not as damaging to health, but as a symb of thriving and prosperous industry. But one factor is almost certainly income. Lack of food and clean water kills more rapidly than does a smoky atmosphere. People will buy food and clean wat before worrying about clean air.

Suppose they were compelled to worry, and to do something about it. What would happe Immediately, costs of production in Mexico would rise. Goods would be more expensive than befor and would either not be exported to the US or exported only in modest quantities, even if trade we free of impediments.

Well-being would be affected both in the US and in Mexico. US residents would not get some good so cheaply and so would be worse off. Because they could not get these goods so cheaply, they cou not afford to buy some other goods. The producers of such goods would be worse off, perhaps out work. Meanwhile, some Mexicans would see the demand for their products disappear, and so they turn could be unable to buy other goods, either from Mexico or elsewhere. In summary, bo producers and consumers, in the USA and Mexico, would be made worse off if the Mexicans were n allowed to make use of some of their relatively abundant resources – cheap air, water and land. Th

policy makes no more sense than it would to say that, before the US is allowed to sell grain to Europ
it has to destroy the prairies.

What of the Mexican environment? Free trade between the US and Mexico will increase demand f
all relatively cheap Mexican resources. Wages in Mexico will rise. And so will the value people pu
on clean air!

It is possible that environmental pollution will not diminish in Mexico. That would follow
Mexican tastes really were very different from those in other countries that have developed an
become rich. In that unlikely event, it would not be grounds for preventing free trade – or at any ra
no better grounds than it would be to prevent free trade with a country because its citizens wore brow
shoes to the office.

Insisting that free trade requires similar environmental standards between countries before trad
starts is equivalent to saying that all relative advantages should be extinguished by law before trad
starts. Acting in accordance with that fallacy would be a recipe for poverty in all the prospectiv
trading partners.

September 199

Free trade has often been an unpopular policy. Various arguments have been advanced against it a various times in the past. The one that has resurfaced recently is that free trade – particularly betwe developed and less developed countries – will cause unemployment in the developed countrie (Interestingly, in the less developed countries fears about the consequences of trade with develope countries are sometimes voiced.)

In fact, it is not true that free trade causes unemployment. It may, however, have an effect on wage this possibility is taken up below.

There are various reasons for engaging in foreign trade. Most obviously, one can buy goods n capable of being produced domestically. This comprises, when one thinks about it, rather a sma group. Minerals, for example, may not be available. But beyond such categories, a lot can be produce if one does not mind the cost. Take the example of Scotland. That country – and Dundee in particul – is the world's leading producer of marmalade. Oranges are a crucial ingredient for that. They cou be grown in Scotland – in hothouses; but they are not, because of the cost.

Cost differences account for a large part of international trade. People in one country buy from oth countries goods which can be produced domestically, but only at a cost so high as to offset any savi in expenditure on transport.

There is a further reason for engaging in international trade.

Suppose that one country was less efficient than the rest of the world in producing *every* good. Le efficient in the sense that it required more units of everything used in production (that is, of eve 'factor of production', to use the technical term) to produce every good in that country than it d elsewhere. Could that country engage in trade? Should it?

The answers are that it both could and should. It can do so by tending to specialise in the producti of what it is least bad at. The reason is that, before trade opens up between this country and the rest the world, prices within the country will be related to costs of production there. Hence the pattern relative prices – the price of one good compared to others – will reflect these costs. This will also true in the rest of the world. Therefore (except in an unusual special case, when *relative* costs production are the same worldwide) relative prices before trade will be different in different countrie Now, where does that lead?

Suppose trade now opens up between countries. What will happen? People will see that relati prices differ in different countries, and will make their purchases accordingly. They will buy whe goods are *relatively* cheaper. There will thus be two-way trade, even though one country has high costs of production than the other. (The exchange rate will move so as to compensate for the production costs.)

The point is important, so an example may be helpful. Suppose in one country production costs a such that before trade the price ratio of two goods is 3:1; and in the other country, the ratio is 1: Then when trade opens up, consumers in the first country will wish to buy the first good overseas; a in the second country, they will wish to buy the second good overseas. Thus both countries ta advantage of relative price differences produced by different production costs.

Each country will tend to specialise in the good which it is relatively more efficient at producin And consumers in each country will gain, from a fall in the relative price of a good. But what abo jobs?

It has so far been seen that trade can take place for three reasons, and that every one of these reason
leads to gains – in the form of either a wider choice of goods or a lower cost of some goods – f
consumers.

These gains are, however, produced by a changing pattern of production. Within each econom
demand switches away from one good and towards the other (or others). What does this do
employment? Plainly it requires workers to move. It does not, however, put them completely out of
job. They are not wanted in one job but they *are* wanted in another – the same force which reduc
demand for them in one activity increases demand in another. *The reduction and the increase*
demand are inseparable. Trade does cause workers to move – but it does not cause unemployment.

There are two qualifications to the above conclusion. First, unless workers can mo
instantaneously, neither requiring retraining nor having to look for work, there will be a *tempora*
rise in unemployment. Second, if the workers cannot become qualified to work in the new jobs
whether through lack of ability or because there are barriers to acquiring the qualification (very lo
apprenticeships required by law, for example) – then they will, indeed, become unemployed. But asi
from that particular case, free trade does not cause permanent unemployment. At worst, it causes
temporary rise in it.

Trade can certainly affect the pattern of earnings in one activity as compared to another, for
changes the pattern of demand for what produces these goods. Models can be constructed which gi
clear-cut predictions of the effect of trade on the distribution of income. But when the complexities
the world are introduced into the models, the predictions are not so clear-cut. Relative wages a
changing all the time, and trade plays a part in producing these changes; but the size, and sometim
the direction, of the effect is seldom unambiguous.

Free trade does not cause unemployment. What it *does* do is change patterns of demand with
economies. This leads to changed patterns of employment, and there can be transition
unemployment while adjustment to this new pattern is going on. Those who maintain that trade caus
permanent unemployment, or that the temporary unemployment it causes should be resisted, are real
saying that the pattern of demand for goods should never change. For it is these changes that requi
changes in the structure of output, and they require changes *regardless* of what has produced th
change in the pattern of demand.

Trade is only one of the many factors that cause economic change. Abandoning free trade would n
prevent economic change; it would only make people poorer, by restricting access to where goods a
cheaper than at home. It is a recipe for poverty, and not even for poverty at high levels
employment.

June 19

Many commentators lament that Britain is running a deficit in the current account of the balance payments. Some worry particularly about our deficit in goods – what is called the visible balance. Th second concern is always misplaced. The first is slightly more complicated. It is therefore better deal with the simple matter first.

International trade is basically of two *types* – trade in goods and trade in services. Exports of eith generate foreign earnings, so, from that point of view, it does not matter what is exported. Indeed, it perfectly normal as countries develop for them to produce and trade in services. International trade services has been in recent years the fastest-growing part of such trade.

Some people worry because manufactured goods have become a smaller part of our output. That is separate concern. But it is worth remarking that the arguments and evidence do not support the clai that it is intrinsically better to produce manufactured goods rather than services.[2]

Given that the composition of exports does not matter, what about their total? Does it matter if v are exporting fewer goods and services than we are importing?

The best way to answer this question is to start with another. How are we paying for these goods ar services? Some of them are paid for by our export earnings. Others are paid for in one of two ways by running down our savings or by borrowing. Like an individual or a company, more can be spe than is earned, provided savings are reduced or borrowing increased. There are many circumstanc where such action is perfectly sensible. There can be favourable investment opportunities, a tempora drop in income, or a chance to buy something more cheaply than usual. There is nothing wrong wi borrowing; what matters is what it is for. If spending is wasteful, it is wasteful whether current incon or borrowed funds are used.

The same is true for a country. If individual decisions by residents, whether firms or individual lead to a current account deficit, then a decision has been taken to spend more than income. If th funds being borrowed to finance that spending are used wisely, there is no problem. If they are n used wisely, then it is foolish spending, *not* the act of borrowing, that is the problem.

A striking example occurred in the United States. On average, that country ran a deficit on curre account from the last quarter of the 19th century into the first decade of the 20th. It did so becau there was a tremendous demand for funds to invest. Population, industry, and agriculture were a expanding westwards. The funds were lent from the residents of European countries, where th expected rate of return on investment was on average lower than in the United States. No one – at ar rate, no one I know of – has claimed that the decline of the US set in with that foreign borrowing. was used productively. The balance-of-payments deficit it engendered was in no way symptomatic a problem.

Sometimes such deficits can be symptoms of problems (though not problems in themselves). F example, the symptom can be of ‘excess demand’. Easy monetary policy may have over-stimulate demand, leading not just to rising prices, but also (as goods become harder to obtain or mo expensive at home) to more purchases from abroad. If the exchange rate is floating, it will be drive down. And if it is pegged, there will be pressure to devalue.

Before summing up, one point remains. If a country is borrowing abroad, it is not necessari increasing *net* overseas indebtedness. That may seem surprising – if a person borrows, his or her deb increase. But even in that case, if he or she has assets, they may be increasing in value more rapid

than the new debts. The same can be true of a country. The value of Britain's overseas assets has i
~~recent years increased more rapidly than her overseas debts; increasing borrowing need not,~~ and
this case did not, bring increased indebtedness.

Now to conclude. Overseas earnings are overseas earnings; it does not matter whether they com
from the sale of goods or sale of services. A current account deficit is not itself a problem. It implie
foreign borrowing. What matters is not the borrowing, but what has produced it and what it is bein
spent on. Current account imbalances are symptoms – but they can be symptoms of sensible decisio
or of folly.

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2 An excellent review of these arguments is contained in N. F. R. Crafts's 1993 Hobart Paper, *Can De-industrialisation Seriously Damage Your Wealth?* London: Institute of Economic Affairs.

In an article published in the *Daily Mail* on 4 April 2014, David Cameron, Britain's Prime Minister, well as saying a good few sensible things repeated a very foolish thing that has been said by mar politicians (and others) in the past. He wrote, a sentiment many will share, 'I am frustrated by th hoops you have to jump through to get anything done.' But just before that, after a list of some these 'hoops', he had written, 'The nations we are competing against don't stand for this kind paralysis.'

This idea that we are in a competition with the rest of the world, and that we have to be better tha them at everything, is nonsense despite the numerous references we see to 'Britain's overse competitors'. This was shown by David Ricardo (the son of an immigrant, incidentally) over 150 yea ago.

Countries can be rich or poor, efficient or inefficient, but they can always compete in world market They specialise according to what is known as *comparative advantage*. And 'comparative' is a ke word. The following demonstration of the argument is essentially Ricardo's.

Start by imagining a country which is not open to the rest of the world. It does not engage at all foreign trade. But there is a market system inside that country. There is internal trade, betwee producers and consumers. The next point to observe is that there cannot be trade without there bein prices. Prices are inevitably *established* by trade. There cannot be one without the other. (That may first glance seem an odd thing to say. After all, we are accustomed to going in to shops and finding th prices already there. But these prices are set by the shopkeeper in the expectation of some trac pattern. If demand turned out differently from expected, prices would soon be changed.)

To summarise so far then, our imaginary economy, cut off from the rest of the world, has a ful developed set of relative prices (the prices of goods relative to other goods). Now imagine that th barriers between this imaginary country and the rest of the world vanish, and the citizens of th economy discover that relative prices are different overseas. For example, suppose that the intern prices were such that if you reduced your wine consumption by one bottle per year, you could with th money buy a pound of cheese. But you discover that overseas, the cheese you could buy if you gave u consuming a bottle of wine was only half a pound in weight. Cheese, in other words, was mo expensive relative to wine abroad than it was at home.

What happens next? Foreigners would observe that by coming to this country and supplying win they could get more cheese than they could at home. For a bottle of wine would buy them a pound, n a half-pound of cheese. And residents of this country would also gain; for prices would adjust reflect the increased demand for cheese, and they would end up with more wine than before and, they wished, no less cheese.

Now residents of both countries have gained, and there has been no mention of how 'competitiv either economy is. We could now assume that to produce either good, either wine or cheese, ou imaginary country which we started with required twice, or three times, or however many times w wished, the amount of inputs per unit of output as did the rest of the world. That does not matter. does not prevent the economy engaging in, and gaining from, international trade.

Trade between countries is not a competition in which there are winners and losers. It is a mutual beneficial activity, from which both sides gain. (There is one special case. If, when a country opens u to trade, it finds that relative prices abroad are the same as they are at home, then there is

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