

Adam Smith versus David Ricardo on Portuguese wine and English cloth

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Abstract

Half a century before David Ricardo's famous numerical example of the exchange of Portuguese wine for English cloth under the Methuen Treaty as illustrating trade creation and comparative advantage, Adam Smith denounced the Methuen Treaty as an instance of trade diversion, displacing British imports of French wines with higher cost, lower quality Portuguese wines. Relying on his argument that the division of labour is limited by the extent of the market, Smith insisted that a treaty of commerce with France would be more beneficial, and supported Eden's Treaty (1786). Smith's critique of the Methuen Treaty, and his posing of the question of which commercial treaties would be trade-creating rather than trade-diverting, has been largely overlooked.

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1. Introduction

David Ricardo's numerical example of trade creation through Portuguese specialization in wine and English specialization in cloth, illustrating gains from trade even when one country has an absolute advantage in both goods, is so celebrated that Andrea Maneschi (2004) writes of "Ricardo's four magic numbers" and Paul Krugman (1998) views an understanding of "Ricardo's difficult idea" as what distinguishes economists from non-economists who write about international relations. Ronald Findlay (1984, p. 186) holds that "Dostoevsky apparently once remarked that all of Russian literature emerged from under Gogol's *Overcoat*. It is at least as true that all of the pure theory of international trade has emerged from chapter 7 of Ricardo's *Principles*." While the various contributions of Ricardo, Robert Torrens, James Mill, and John Stuart Mill to the principle of comparative advantage remain the subject of debate (Maneschi 1998, Ruffin 2002, Gomes 2003, pp. 35-42, Aldrich 2004), attention continues to centre on Ricardo's example using a choice of countries and commodities clearing intended to recall the Methuen Treaty of 1703.

What this literature overlooks is that, long before Ricardo, Adam Smith wrote and lectured about the exchange of Portuguese wine for English cloth under the Methuen Treaty and that, where Ricardo saw trade creation, Smith denounced the treaty as a trade-diverting interference with free trade. Smith's critique of the Methuen Treaty is not remarked even in articles or chapters devoted specifically to Smith's views on foreign trade by Samuel Hollander (1973, pp. 268-276), Douglas Irwin (1996, pp. 75-86), Edwin G. West (2000), and Leonard Gomes (2003, pp. 30-35, although on pp. 78-79 Gomes notes List's criticism of Smith over the treaty without making clear Smith's position). C.

R. Fay (1950, p. 140) quoted Smith (1776) as stating that the Methuen Treaty was “celebrated as a masterpiece of the commercial policy of England” without noticing that Smith then firmly disagreed with those who so celebrated the treaty. Smith’s opinion on the exchange of Portuguese wine for English cloth was not always as little-known as it has been in recent decades: Lodge (1896), writing on the Methuen Treaty in Palgrave’s *Dictionary*, stated Smith’s views clearly.

2. The Methuen Treaty

The treaty between England and Portugal, negotiated in Lisbon by the English envoy John Methuen, was signed on December 27, 1703, in the course of Portugal changing sides in the War of the Spanish Succession. The brief, three-article treaty (translated in full in Smith 1776, p. 546) provided that English woollens, excluded from Portugal for protectionist reasons since 1680, would be admitted “for ever hereafter” on the terms prevailing before the prohibition, and that Portuguese wines would pay a duty in England (Great Britain after the Union of 1707) one-third less than the duty on French wines.

Portuguese wine exports to Britain grew (see Hancock 2003 on the marketing of Madeira), displacing the French wines that England had imported ever since Eleanor of Aquitaine brought Bordeaux to the English crown (see James 1951 on the medieval Anglo-Gascon wine trade). Pepys drank claret (referring to Chateau Haut Brion as Ho Bryan) but a century later Johnson and Boswell drank port. However, port (not then a fortified wine) was drunk in England before the Methuen Treaty: J. H. Plumb (1966, p. 165) reports that “In October 1698, Colonel Walpole, Sir Robert’s father, purchased ... thirty-eight gallons of red port in cask. The next month he bought a half hogshead. The

following April a further hogshead of red port and at the same time half a hogshead of white wine; later in the year he bought another sixty gallons of red port and a hogshead of white Lisbon” at fifteen pounds for a hogshead of red port and sixteen pounds for one of white Lisbon. Nor did the tariff preference for port completely end English consumption of claret: in 1732-33, Sir Robert Walpole bought four hogsheads of Chateau Margaux at a time and a hogshead of Chateau Lafite every three months, for forty-five pounds a hogshead (Plumb 1966, p. 167).

English woollen exports to Portugal grew even more than Portuguese wine exports to Britain, so that English mercantilists could take pleasure in an inflow of one-half to one million pounds sterling of Brazilian gold (Gomes 2003, p. 14, Smith 1776, p. 547). The editors of the Glasgow bicentennial edition of *The Wealth of Nations* (1776, p. 546n) quote Charles King’s 1752 dedication of *The British Merchant* to Methuen’s son: “Your father ... procured for Great Britain that glorious Treaty of Commerce, by which She gained above a Million a Year.” In contrast, Adam Smith (1776, pp. 548-49) attached no importance to the fact that “Almost all our gold, it is said, comes from Portugal” since “The effectual demand for gold, like that for any other commodity, is in every country limited to a certain quantity ... the more, that most insignificant object of modern policy, the balance of trade, appears to be in our favour with some particular countries, the more it must necessarily appear to be against us with many others.” In Smith’s version of what came to be called the monetary approach to the balance of payments, trade balances serve to allocate the world’s supply of gold among countries in proportion to their demand for real money balances, as an excess demand for gold in a gold-importing country such as Britain leads people to accumulate gold by spending less than their current income on

other commodities, including imports, and an excess supply of gold in a gold-producing country such as the Portuguese Empire led to spending of gold on other goods, including imports (see Laidler 1981, Humphrey 1981).

Unlike Smith, an influential contemporary of his was persuaded by the boasting of English mercantilists such as Charles King that Britain's trade surplus with Portugal demonstrated the Methuen Treaty involved British gain and Portuguese loss. Sebastiao Carvalho e Melo, better known as the Marques de Pombal (his title from 1769), Portuguese minister in London from 1738 to 1743 and a Fellow of the Royal Society of London (which Smith later joined), owned copies of the writings of such mercantilists as Thomas Mun, William Petty, Charles Davenant, Charles King, Joshua Gee, and Josiah Child, and wrote a report in 1741 denouncing the unfair advantages enjoyed by British merchants in Portugal (Rodrigues and Craig 2004). As chief minister of Portugal from 1750 to 1777, Pombal strove with some success to end British dominance of Portuguese commerce (Shaw 1998), turning the English mercantilist view of the Methuen Treaty against England.

3. Smith on Portugal and France as trading partners for Britain

In an early draft of part of *The Wealth of Nations*, written between 1759 and 1762, Smith (1978, p. 578) recorded his intention to write "Of the British trade to France and Portugal. That a free trade to France would tend infinitely more to enrich Great Britain than a free trade to Portugal, because France, on account of its superior opulence having more to give, would take more of us, and exchanging to a much greater value and in a much greater variety of ways, would encourage more industry in Great Britain and give

occasion to more subdivisions of labour; and that it is only passion and national prejudice which ever made anybody think otherwise.” In addition to this stress on the division of labour being limited by the extent of the market, Smith (1978, p. 577) argued, “If you prohibit the importation of French claret, for example, you discourage all that industry of which the product would have been exchanged for French claret. Whether that industry would have been exercised in making a piece of broad cloth, or in bringing gold from the Brazils, is of no consequence to national opulence.” In *The Wealth of Nations*, Smith (1776, p. 661) protested, “By the famous treaty of commerce with Portugal, the consumer is prevented by high duties from purchasing of a neighbouring country, a commodity which our own climate does not produce, but is obliged to purchase it of a distant country, though it is acknowledged that the commodity of the distant country is of a worse quality than that of the near one. The home-consumer is obliged to submit to this inconveniency, in order that the producer may import into the distant country some of his productions upon more advantageous terms than he would otherwise have been allowed to do” (see also Smith 1776, p. 475, on the gain from buying cheaper and better French wines instead of Portuguese wine, even if Britain then runs a trade deficit with France). In that passage, Smith based his criticism of the Methuen Treaty’s diversion of English wine imports from France to Portugal on absolute advantage, while his criticisms of the treaty in both the early draft and his lectures emphasized economies of scale and that the division of labour is limited by the extent of the market (the topic and title of the third chapter of *The Wealth of Nations*).

Smith posed the question of which customs unions would be most beneficial and trade creating. Beyond criticizing the treaty of commerce with Portugal as diverting trade from

its most advantageous channels, Smith (1978, p. 392) argued in his lecture on April 13, 1763, that, in contrast, free trade with France would be trade creating, expanding the market and so extending the division of labour: “Portugall contains about 2 mills of men; France on the other hand contains about 20 mills. The exchanges which would be made to France would probably be 100 times those made to Portugall, and a free trade to it would therefore excite much greater industry than one to Portugall. For 20 millions in a society, in the same manner as a company of manufacturers, will produce 100 times more goods to be exchanged than a poorer and less numerous one of 2 mill. ... By our prohibiting French wines we are supplied intirely by the Portugese at a higher price and in inferior quality than we would be from France.” It is noteworthy that Smith made this case for free trade with France just at the close of the Seven Years War (1756-63) between Britain and France, and as his friend David Hume was going to Paris as secretary to the British ambassador upon the restoration of diplomatic relations. However, Smith’s advice was not taken until the Anglo-French commercial treaty of 1786, negotiated by Smith’s friend William Eden (later Lord Auckland) and advocated by the physiocrat Pierre-Samuel Dupont (later Dupont de Nemours)², a treaty whose sixth article lowered duties on French wines to those on Portuguese wines (in violation of the Methuen Treaty, which had not been abrogated). While the negotiations were underway, Smith added two paragraphs to the 1784 edition of *The Wealth of Nations* arguing (on the same grounds as in his lectures two decades earlier, at the close of the previous war with France) that free trade with France would result in a commerce far exceeding that which

² See Smith to Eden, 3 January 1780 and 15 December 1783, in Smith (1987, pp. 244-46 and 271-72), Dupont (1788), Dupont to Smith, 17 June 1788, in Smith (1987, pp. 311-13), Lodge (1896, p. 748), Fay (1950, pp. 17, 468-69).

Britain had lost with the independence of most of its North American colonies the year before (Smith 1776, pp. 495-96).

Smith rounded out his denunciation of the Methuen Treaty with two minor arguments. One was the cost of defending a weak ally in wartime: “It was upon this silly notion, however, that England could not subsist without the Portugal trade, that, towards the end of the late war [the Seven Years War], France and Spain, without pretending either offence or provocation, required the king of Portugal to exclude all British ships from his ports, and for the security of this exclusion, to receive into them French or Spanish garrisons. Had the king of Portugal submitted to these ignominious terms which his brother-in-law the king of Spain proposed to him, Britain would have been freed from a much greater inconveniency than the loss of the Portugal trade, the burden of supporting a very weak ally, so unprovided of every thing for his own defence, that the whole power of England, had it been directed to that single purpose, could scarce perhaps have defended him for another campaign” (Smith 1776, p. 549).

Smith also complained that, while the treaty gave Portuguese wines an advantage over French wines in the English market, it gave no such advantage to English woollens over French or Dutch woollens in the Portuguese, only guaranteeing that the import duty could not be raised above what it had been before the importation of English woollens was prohibited in 1680: “So far this treaty, therefore, is evidently advantageous to Portugal, and disadvantageous to Great Britain”³ (Smith 1776, pp. 546-47). Here Smith let himself

³ Gomes (2003, p. 80) quotes Friedrich List’s criticism of this remark by Smith on the grounds that British products undermined Portugal’s textile industry, and also quotes Sideri (1970) on the resulting diversion of Brazilian gold to Britain. These are hardly telling criticisms: the whole point of specialization and exchange is the shift of resources out of one sector (Portuguese textile manufacturing) into another, while Smith was well aware of the inflow of Brazilian gold into Britain, arguing that the British demand for gold would be satisfied under free trade without any such contrivance as the Methuen Treaty.

be carried away by his opposition to the treaty: he was well aware that opening the Portuguese market to English woollens after nearly a quarter century of prohibition had led to substantial imports of English woollens. Furthermore, as Edwin G. West (2000) documented, Smith's general position was to endorse unilateral free trade, rather than reciprocity. Indeed, elsewhere in *The Wealth of Nations*, Smith responded to the argument that Britain should favour the wine trade of Portugal because "The Portuguese, it is said, are better customers for our manufactures than the French" with a vehement protest that "The sneaking arts of underling tradesmen are thus erected into political maxims for the conduct of a great empire: for it is the most underling tradesmen only who make it a rule to employ chiefly their own customers. A great trader purchases his goods always where they are cheapest and best, without regard to any little interest of this kind" (Smith 1776, p. 493).

Lodge (1896, p. 749n) records another Scottish critique of the Methuen Treaty:

Firm and erect the Caledonian stood

Good was his mutton and his claret good.

'Let him drink port,' the English statesman cried.

He drank the poison and his spirit died.

4. Conclusion

Paul Krugman (1990, p. 4) holds that "the long dominance of Ricardo over Smith – of comparative advantage over increasing returns – was largely due to the belief that the alternative was necessarily a mess. In effect, the theory of international trade followed the perceived line of least mathematical resistance." It was easier to dismiss Smith's analysis

of international trade as “vague and unscientific, if not positively false” (John Stuart Mill, quoted by Aldrich 2004, p. 381). Similarly, the question posed by Smith of which customs unions would be trade-creating and which trade-diverting was ignored as long as there was no clear idea of how to formalize it. Andrea Maneschi (2004, p. 441) remarks, with reference to the rediscovery of Sraffa (1930) by Ruffin (2002), that “The history of economic thought contains many examples insights gained by earlier economists that were subsequently lost.” Adam Smith’s discussion of the exchange of Portuguese wine for English woollens under the Methuen Treaty, which was considerably more extensive than Ricardo’s discussion, is another instance of this phenomenon. The Methuen Treaty might seem ideally suited for Ricardo’s illustrative purposes, since it was well known as establishing a trade between two countries in two goods where that exchange had previously been prohibited (at least in one direction). Ricardo’s numerical example of the exchange of Portuguese wine for English cloth, brilliant in demonstrating the possibility of mutual gains from voluntary exchange even when one trading partner has an absolute advantage in both goods and fruitful in its stimulus to the analysis of comparative costs, had a weakness: it did not apply to the exchange of Portuguese wine for English cloth, because it misrepresented the establishment of that commerce as trade creation, rather than diversion. Smith, with less formal theorizing but greater empirical awareness and immediate policy relevance, denounced the Methuen Treaty as trade diversion, and successfully supported its replacement by Eden’s Treaty with France. The displaced alternative to British consumption of Port and Madeira was British consumption of Bordeaux and Burgundy, not of English wines.

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