15

Serra's *Breve trattato* and the Theory of Economic Development

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1 Serra in the 21st century

What can we take away from reading an obscure treatise, written some four hundred years ago? One might expect that it would allow us to measure the progress that has been made in economics since that time. However, what it does is make very evident how much economics has changed from a practical subject that deals with economic policy to improve living conditions, to a theoretical subject carried on primarily for the amusement of its practitioners.

One of the most striking aspects of Serra's *Breve trattato* is the way in which it brings into focus the difference between what used to be called "Political Economy" and modern day theoretical economics. Instead of starting from a mass of identical economic agents in a closed economy without a government that has real endowments of undifferentiated resources, Serra starts with an economy in which international trade is an integral part and the government is responsible for the operation of the economy. He also stresses the importance of skill and quality differences in the labour force and the different performance of different economic activities, in particular between agriculture and manufacturing. Furthermore, he gives a prominent role to uncertainty in assessing the contribution of different types of economic activity. Finally, Serra is clear on the importance of monetary analysis, declaring early in his *Breve trattato* that anyone who does not recognize the benefits of the economy of abundant supplies of gold and silver should be considered for an extended stay in a lunatic asylum. It is particularly touching that being in prison at the time, he points out that one of the

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benefits of abundant supplies of money is a reduction in the crime rate. We don't know why he was in prison, but we might accept arguments suggesting he was a counterfeiter or even assume that it was for lack of sufficient funds to meet a contractual commitment.

From this starting point, it is not surprising that Serra provides what is the first modern account of a country's balance of payments, including the importance of international capital flows, as well as the importance of domestic and external indebtedness. It is this aspect which provides a special view on the real views of the mercantilists. These economists came under heavy criticism from both the physiocrats and classical economists for a supposed failure to distinguish between gold and what could be bought with it. The former pointed out that only the natural productivity of land provided for increasing wealth, while we are still living with the mistaken extension of Hume's argument that the value of gold depended on the amount of goods it could buy in the form of the quantity theory of money. Locke was much more sensible in arguing that it depended on the labour available to be put to work.

But Serra clearly cannot be convicted of this kind of error, because he argues against policies of prohibition of the export of gold normally associated with the mercantilists. Instead, he sees the world more from the point of view of Marx and Keynes (a well-known defender of the mercantilists), arguing that you have to spend money to get money. M-C-M'. If you don't use the money to buy inputs or imports, you cannot get more of it by selling at a profit. Further, he argues that you can profit more by engaging in particular kinds of economic activities such as entrepôt trade and manufacturing.

In addition, Serra provides a theory of economic development that previews the theories that became popular in the wake of World War II, associated with the works of Raul Prebisch, Ragnar Nurkse, Gunner Myrdal, and other pioneers of development – in particular, the impact of external capital flows and the importance of the development of domestic industry to a successful development strategy. In this respect, Serra becomes not only a precursor of Adam Smith in analysing the causes of the wealth of nations but also a pre-pioneer development economist.

2 Serra's main message

Unfortunately, much of Serra's main message is hidden in a dispute with de Santis. The point at issue is how the deficiency of money in Naples can be remedied, but this really means how the poverty of the Kingdom

of Naples can be overcome and how the growth of per capita Neapolitan domestic incomes can increase. The position of de Santis was that the lack of money in the Kingdom was due to the excessively high level of the exchange rate, leading to the use of bills of exchange instead of monetary metals. Thus, bills were substituting for metallic currency. On the basis of his theory, several measures had been introduced to manage the rate of exchange and to limit the export of metallic money, without producing any positive impact on the situation.

Serra, on the other hand, starts by noting that there are countries with no natural supplies of metals from domestic mines but that nevertheless manage to have an abundance of money. He thus seeks to develop a general theory of how countries without natural supplies of precious metals manage to accumulate them, then to apply this theory of the conditions present in Naples, and then to use it to assess the impact of the exchange rate.

Rather than deal with the technicalities of foreign exchange markets and financial derivatives[1], his approach is straight forward – look at the factors that create an abundance of metals in those countries that do not possess the natural advantage of having domestic mines of gold or silver. He notes that these countries can be divided into two groups: those that have other inherent domestic or natural advantages other than domestic gold mines, such as exceptionally productive land or climate or a peculiar geographical position; and those that allow them to act as an entrepôt for trade. For these countries that are subject to conditions that are more or less equivalent to the accident of discovering a gold mine, there can be no general explanation or policy, since the conditions cannot be replicated by policy and as such Serra excludes them as possible remedies for the problems confronting the Kingdom of Naples.

Thus, Serra concludes that the answer has to be sought elsewhere, in conditions that could be applied in any country, what he calls common causes or common "accidents"; in the sense that they can potentially be introduced by any country, they are not particular or peculiar to its position. Of these "accidents", he identifies four that are associated with the existence of an abundance of metals – extensive manufacturing, integration into the international trading system, a skilled and enterprising labour force, and good government.

3 The four common factors

Here Serra is clear of the standard criticism of mercantilism because there is no mistaking gold for what it can buy. Instead, Serra starts by looking

at the real conditions of production – you can acquire gold only if you have something to exchange for it. He notes that Naples does have a natural predisposition to produce more than it needs for its subsistence, which means that a simple excess of production cannot be a sufficient explanation for the lack of metals, since Naples has excess production that it exports and still has a deficiency of domestic circulation.

This brings him to the nature of production, and here he departs from the physiocrats by noting that manufacturing, as well as agriculture, allows for surplus production. In particular, he notes that manufactures will differ from agriculture because of the existence of increasing returns that will ensure an abundance of goods available for trade. But it is not only this technical condition of production that he considered important. Serra notes that since agricultural production will be subject to the vagaries of the weather, it would be ill-suited to the needs of trade. It will also be subject to the vagaries of fluctuations in demand since commodities are in general perishable. Manufactures, on the other hand, can always be stored and sold abroad in the event of fluctuations in domestic demand. He thus concludes that returns to manufacturing should be higher due to the lower uncertainty of earnings.

In addition, a multiplicity of manufactures will be beneficial to providing more stable external markets since it provides for diversification across different sources of external demand. Serra thus concludes that the existence of a multiplicity of manufactured goods will be more important than the natural excess capacity in the production of commodities.

But, Serra goes on to note that even a multiplicity of manufactures may not be enough to produce an abundance of money if the domestic population is not sufficiently skilled and industrious to engage in manufactures and creative in seeking markets in which to trade them. Indeed, this second common cause that is the result of an enterprising population becomes a major factor in his explanation of the absence of money in Naples since it provides an opening for foreign investors to dominate the local market.

Serra suggests that the domestic Neapolitan population is indolent, which means that it is little involved in manufacturing or creative innovation and seeks little in trade opportunities outside the Kingdom of Naples. As a result, what domestic manufacturing exists is in the hands of foreigners, who also are in control of the export trades and of import and the domestic sale of manufactured goods. This, in the end, becomes the key to Serra's explanation of the problems facing Naples.

Further, Serra notes the interactive and cumulative effect of manufactures and extensive trade: the larger the range of manufactures, the larger the possibilities for trade; and the larger the possibilities for trade, the more manufacturing businesses that can be supported. It is important to note that for Serra, the idea of extensive trade is different than that of the export of surplus goods that results from the natural advantage of an excess of domestic production over domestic use. Rather, it relates to the kind of entrepôt trade that results from a natural geographical location but that can be the result of an industrious population even in the absence of the locational advantage. But, as Serra notes, Naples has neither the appropriate population, nor the correct geopolitical location to take advantage of this accident.

Finally, having outlined the three main common factors or accidents that could be introduced in order to produce an abundance of money, Serra notes that they will exist only if the government is sufficiently knowledgeable and has the capacity to introduce them and make them effective. This, then should become the necessary condition to ensure the introduction of measures that create the other common accidents and ensure the inflow of precious metals. However, Serra does not follow this logic, instead falling back on the importance of uncertainty in economic analysis. In ranking the potential impact of the common causes, he notes that that of the multiplicity of manufactures is more certain in its impact than any of the others, including good government, which depends on the volition of an individual leader. Serra thus concludes that since Naples has no natural accidents or advantages and that since its government, no matter how effective, has not been able to ensure an active manufacturing sector or extensive trade – because of the unskilled and unmotivated population – it should not be a surprise that Naples lacks wealth and money.

However Serra's adversary – de Santis – had already argued and convinced the rulers of Naples that although the Kingdom had plenty of gold at one time, an inappropriate high exchange rate had caused it to be sent abroad. The problem was thus not in the existence or absence of common accidents, as Serra proposed, but rather in the setting the appropriate exchange rate.

4 Confuting de Santis

Since the exchange rate does not enter as one of Serra's common causes, it is necessary for him to counter de Santis's argument. Serra does this by arguing on both the theoretical level and the empirical level. His

clearest area of dispute with de Santis concerns the quantitative facts of the case in dispute. Both agree that Naples satisfies Serra's natural advantage of being able to produce more than it consumes, and thus, it should be able to export the difference, receiving large inflows of precious metals in return. Thus, the question at issue is then why these massive exports do not generate earnings and provide for an abundance of money. But here the agreement between the two writers ends. For de Santis, Neapolitan exports are around five million ducats per annum; Serra, on the other hand, credits Neapolitan exports with earnings of more than six million ducats. Given this large export base, the question that is in dispute is why it does not produce a greater flow of precious metals. Here, both agree that the important point to debate is what prevents gold from flowing into the country of an amount equal to the Kingdom's exports.

But here the agreement stops: although both agree that the important figure is not gross exports but instead net exports, there is no agreement on whether net exports are positive or negative and why. For de Santis, Naples has annual imports around 600,000 ducats and has a foreign resident population that expatriates their investment earnings in a roughly equal amount, leaving a net external surplus position of 3 million less 1.3 million ducats, which leaves 3.8 million ducats (or 4.8 on Serra's estimate of gross exports). Given a metallic standard for the currency, this should produce an inflow of gold or silver of a similar amount. The explanation given by de Santis for why this does not happen is that the high exchange rate induces foreigners to use bills of exchange to pay for the goods that they export from Naples, rather than using money. But, as Serra counters in an argument that becomes repetitious, if bills are used to buy Neapolitan exports rather than money, then some money to meet the bills must have been brought into the country previously, in which case Naples would not lack metals.

Serra's more direct argument disputes the calculation of imports, noting that the lack of manufacturing capacity makes it necessary to import textiles of an amount that could be as high as three million, spices of an equivalent amount, as well as drugs, books, processed metals, and on occasion even wheat, producing as estimate of imports that is in the range of the entire value of exports. But that is not all. Serra notes that foreigners account for the major part of domestic investment and thus have investment earnings, that they are the major exporters and manufacturers and thus earn large domestic profits, and finally that they are responsible for the import and sale of manufactures, which also earns income for them.

What Serra has done is introduce the concept of the factor services balance and the capital account into the argument. He thus offers a counterargument to de Santis, noting that even if there is a small surplus in the commercial balance, the prior capital inflow has been sufficient to offset any possible export surplus, so that when the factor services balance is taken into account, the current account is most certainly in deficit. This leads to the conclusion that the mystery is really not at all about what happened to the missing 4.8 million ducats but the explanation of why there is any money left in the Kingdom at all! Indeed, Serra argues that it is only because foreigners do not repatriate their earnings that there is any gold left in the country. If this were not enough to make the argument, it ignores the fact that Naples was required to make tax payments to Spain as a colony. All of these factors, taken together, suggest that foreign claims more than exhaust the demand for domestic claims due to exports.

Thus, the argument about the facts seems to provide full support for Serra's theoretical position. While Naples has large exports, those exports are of primary commodities, not manufactures. Nor does Naples engage in extensive or entrepôt trade, and both of these factors can be attributed to the indolence of the domestic population. Thus, there is no reason to expect that there should be a current account balance that leads to an inflow of money.

5 Reading the balance of payments through the common factors

We can thus link each of Serra's proper and common causes or accidents to his interpretation of the sign of the entries in the Neapolitan balance of payments accounts. The large export credits in the goods balance are explained by the proper accident of an abundant natural production of commodities that exceed domestic needs. However, this is more than offset by the size of manufactured imports, due to the absence of the common accident of a diverse manufacturing sector and the absence of the common accident number two of an energetic and skilled population that together lead to the absence of extensive trade in manufactures. The negative factor services balance is also explained by the lack of common accident number two because the lack of initiative in the domestic population allows foreign owners to dominate external trade and domestic investment and production. The deficit is further aggravated by the lack of common accident number four, effective government, which leads to charges payable to the Spanish government

(although both seem to argue that there is an inflow of funds on this account that are wholly spent within the country). Finally, the capital account balance is determined by the dominance of foreign investment, again due to the lack of domestic initiative and the colonial status of the Kingdom.

This is the positive part of Serra's argument. However, most of the book is dedicated to disputing de Santis's claims by showing that the lack of the common factors is more important than the impact of the exchange rate. Thus, he argues that even if it were true that de Santis's argument were correct, that thus the exchange rate influenced the use of bills of exchange (which, as noted, Serra did not accept), a change in the exchange rate could not benefit Naples, because it would not induce any of the common factors required to produce an inflow of money.[2]

6 The real problem – foreign investment

Despite his emphasis on the common accidents, Serra's final judgement is that the problems facing Naples are caused by the negative capital services account because "the income that foreigners receive from their businesses, combined with their income from imported goods far exceeds any income that could be made from the export of goods".[3] He again repeats the point when discussing the embargo on exports of money introduced on the basis of de Santis's arguments and a standard mercantilist position, noting that "the reason why the exportation of money causes such harm in our Kingdom is the disorder which has been allowed to develop of foreigners receiving too much income from investments and controlling all the businesses of the kingdom; for, this being the case, since the exportation of money is permitted, there is no need for the money that leaves the Kingdom ever to return".[4] Indeed, he argues that the only benefit of a ban on currency exports would be preventing foreigners from expatriating their profits.

Serra thus continually repeats that the "real reason" why money does not come into the Kingdom in exchange for exported goods is the income that foreigners have from their investments in the Kingdom and their profits from the businesses that they own there. Therefore, the more opportunities that one gives them to trade with advantage and profit and to buy shares and assets, the less money will enter the country in exchange for the exported goods. And those goods are the Kingdom's only resource".[5] Again, "where the export of money is positively harmful is when the money derives from the income from investment and profits from businesses that foreigners receive in the Kingdom. In such cases, as

I have explained a ban on the exportation of money is advisable in the Kingdom, even though it would not be elsewhere".[6]

7 What is to be done?

Thus, when Serra considers the conclusions of his analysis, he is hesitant to give any particular proposals, but rather, he relies on very general proposals based on his basic approach: first, remove the cause that prevents money from entering the Kingdom – basically, the factor services deficits caused by foreign investment; second, introduce those common accidents that will increase the inflow of money; and finally, ensure that the first two measures succeed.

Thus, the first order of business is to eliminate "[t]he causes that prevent money from entering the Kingdom even though about six million ducats' worth of goods are exported every year", they "are three in number: first, the income that foreigners receive from their investments in the Kingdom; ... second, their profits from the businesses that they own here; third, their profits from the importation of essential goods into the Kingdom. The total value of these causes is far higher than that of the exported goods, even if the level of exportation were increased, and this is why money does not enter the Kingdom in exchange for exports" (p. 52).

The natural remedy would be to limit foreigners' income, but Serra notes that there is no money to give back to them, and he is not willing to consider limiting their capital exports or expropriation, although he does suggest that such limiting is a possibility in the name of the public good, but that it is not consistent with the normal definition of justice, and that, in any case, it might cause more harm than good. The same arguments apply for the business interests of foreigners, as well as their financing of the imports trade.

This creates a policy conundrum for Serra since it appears that nothing can be done to remove the causes that impede the inflow of money since it is difficult if not impossible to limit the negative impact of foreign direct investment. But here Serra's general theory comes to his aid in that he notes that the second cause of the lack of money flowing into the country is directly linked to the absence of the most important of the common accidents. Thus, he suggests that it is better for the government to try to create the appropriate common accidents – that is, to build a domestic industrial sector and to build a domestic entrepreneurial class and a skilled labour force – than to try to remove the impact of foreign direct investment. And the introduction of the

domestic manufacturing industry will automatically solve the problem of the profits made by foreigners from manufactured imports.

This, of course, sounds very much like the much maligned policies of import substitution industrialization much criticized in Latin America following World War II However, it is much closer to the more refined policies of the early pioneers of development, who argued that developing countries could overcome their external, balance of payments constraint only by building up a source of domestic exports capable of generating foreign exchange. While Serra does not invoke the traditional argument of the trend deterioration in the terms of trade, he does recognize an even more important constraint: the difficulty of meeting external claims that result from foreign investment. He recognized this some four hundred years before the difficulties that resulted from the same problems and produced the lost decade of the 1980s. Serra provides not only evidence of the importance of political economy but also an answer to the problems of developing countries in the 1980s. Had Serra lived in the current century, he certainly would have provided cogent arguments against the early liberalization of capital accounts for countries undergoing development.

Notes

1. Without direct knowledge of the conditions of foreign exchange markets in 17th-century Italy, this discussion is virtually impossible to understand. Rosselli, A., "Early Views on Monetary Policy: The Neapolitan Debate on the Theory of Exchange" *History of Political Economy* Vol. 32 No. 1, 2000, provides a useful guide to conditions prevailing at the time, but even this does not provide a clear guide to understanding de Santis's argument on the issue.
2. Here the argument follows Roncaglia, A. (*The Wealth of Ideas: A History of Economic Thought*, Cambridge, Cambridge University Press, 2005, p. 50) who notes that "Serra considered the unbalance in the currency market to stem from a negative balance of payments, inclusive of so-called invisible items. In turn, this situation was seen to derive from a feeble productive structure and the scant entrepreneurial spirit of the subjects of the Kingdom of Naples: the theme that Serra chose to open his *Breve trattato*. There was, then, a decisive connection between scarcity of money in the Kingdom and its feeble productive structure".
3. Serra, A., *A Short Treatise on the Wealth and Poverty of Nations,* ed. S. A. Reinert, trans. Jonatan Hunt, London: Dehli: Anthem, 2011, p. 195.
4. *Ibid.*, p. 215.
5. *Ibid.*, p. 219.
6. *Ibid.*, p. 231.