

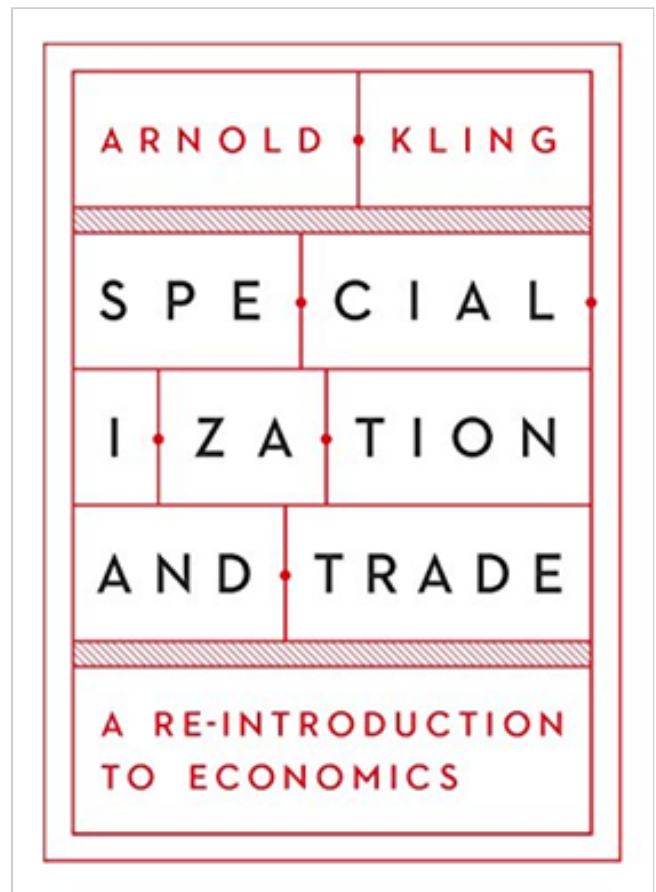
Economic growth through the lens of changing patterns of specialization and trade

Specialization and Trade: A Re-introduction to Economics.
By Arnold Kling. Washington, DC: Cato Institute, 2016, 208 pp., \$9.99 paperback.

In their first economics course, college students learn the concept of comparative advantage. They usually study a purposely absurd scenario in which two people are stuck on a desert island and have to decide which of them will fish and which will pick fruit. Eventually, they end up specializing in one or the other activity and begin to trade with each other for mutual benefit. By analyzing this example, students learn that specialization and trade make everyone better off.

In *Specialization and Trade: A Re-introduction to Economics*, libertarian and free-market enthusiast Arnold Kling makes a similar point by illustrating the benefits of specialization and trade through a clever example about the complex network of people and tasks that make it possible for us to eat a bowl of cereal. For this possibility to materialize, says Kling, we would need to find and mine metals, construct tools, plant and harvest wheat, process the wheat in a factory built from mined metals, package the cereal in boxes made from trees that must be planted and harvested, and, finally, after more similar steps, acquire the milk and spoon used to consume the cereal. You get the point. Many people specialize in many different tasks to bring us a bowl of cereal, and similarly complex networks of specialization exist throughout our economy.

After illustrating the importance of specialization, Kling states that he wants to clear up common misconceptions about economics, specifically those concerning specialization and trade. He argues that the economic models used since World War II have perpetuated most of these misconceptions. During the war, resources in the United States were extremely scarce, because most of them had to go toward the war effort. As part of an initiative to



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allocate these resources more efficiently, the Massachusetts Institute of Technology (Kling's alma mater) led the creation of complex mathematical economic models that were based on solving constrained optimization functions, an effort that continued in the postwar period. Kling writes, however, that economic behavior cannot be predicted by solving a series of equations that may use shaky assumptions or omit important variables. Such behavior evolves and adapts, and it does so through changing patterns of specialization and trade.

Kling lays out many of the different outcomes that result from specialization. Among these are increased wealth, improvements in transportation and infrastructure (the world is now more interconnected, making specialization possible), expansion of trade (as more specialization takes place, more people need to trade to meet their needs), urbanization (a denser population makes specialization and trade more feasible), increased social complexity (societies evolve from simple to more advanced and specialized), market growth (as the consumer base grows, so does the degree of specialization), higher capital intensity, and greater importance of financial intermediation.

Kling arranges the book around key topics, such as economic incentives, sustainability, trust, finance, and policy. These topics capture the factors that, in his view, shape and organize the way in which specialization and trade take place in the economy. Early in the book, Kling introduces the idea of the *GDP factory*, which he consistently uses to represent aggregate demand. He argues that, in trying to stimulate or constrain aggregate demand, economists and policymakers treat the entire economy as one big industry. When the economy is hot, aggregate demand is strong; when the economy is in recession, "part of the *GDP factory* shuts down" and there is unemployment. Kling says that viewing the economy this way is unrealistic, arguing that, because of changing patterns of specialization and trade, the economy is far too dynamic to be properly represented by the *GDP factory*.

Entrepreneurship is a theme that cuts across all key discussions in the book. The reader learns that incentives (prices and profits) guide entrepreneurs to the most efficient uses of their skills. These entrepreneurs then create jobs, or specializations, for workers to fill. Kling writes that unemployment is part of the cycle of specialization. When people specialize in jobs that eventually become unprofitable, they find themselves out of work and must find new specializations. The author claims that a change in monetary or fiscal policy is not very useful in addressing this problem. Instead, entrepreneurs are needed to innovate and discover new methods of specialization, which in turn create new jobs that can replace lost ones.

Kling casts specialization as the focal point of economics. The economy is dynamic, he says, because of altering patterns of specialization. And he is explicitly clear that, in order to specialize, we need to trade. People only trade if they trust the economic system. Kling leaves the reader with an important rule: "reward cooperators and punish defectors." He also emphasizes the key role of financial intermediaries in fostering trust and promoting specialization in the economy. Such intermediaries connect savers and borrowers, allowing them to "trade across time" and to obtain the funds necessary to buy capital that drives specialization. Finally, Kling warns against using outdated models to justify interventionist policy. He recommends policies that address unemployment by promoting sustainable specialization, a goal achievable only through encouraging competition, innovation, and labor and capital mobility.