International Economics

Chapter 3

The Classical Theory of International Trade

Summary

In this chapter you will learn:

1. Pre-Classical Theory of International Trade.
2. Adam Smith's Theory of Absolute Cost Difference.
3. David Ricardo's Theory of Comparative Cost Advantage.
4. JS Mill's theory of Reciprocal Demand.

3.1 Introduction

Why does or under what conditions does IT take place? Or what are the terms for the trade and how are they determined? These are the questions addressed under Theory of International Trade [IT]. Classical economists Adam Smith and David Ricardo attributed the IT, to absolute and comparative cost differences respectively. Explanation for these differences was offered by economist B Ohlin.

Economist Ohlin, however, did not agree for a different theory for IT, as he argued it was similar to inter regional trade. Mobility of labour is neither totally perfect within a nation nor is it absent between two countries. Goods always move from area [either within or outside the nation] of plenty to area where they are scarce. Principle of specialization is applicable universally & not only in trade across countries.

Other economists, however, insist for a separate IT theory as it involves complex foreign exchange issues, restrictions placed or incentives offered by sovereign governments of trading countries.

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3.2 Pre-Classical Theory of International Trade.

With emergence of monetary economies that replaced barter trade, economists argued that the best way for the countries to survive and grow was to hold large stock of Gold & Silver. With this stock, they could build armies for protection and buy necessities, not available locally, from other countries.

Gold reserves can be built, if there are adequate gold mines in the country. If not, [like UK] the country has to export goods & services to build gold reserve. This requirement, as per pre-classical economists known as mercantilists, gives rise to international trade.

To maximize the stock of gold, the country should increase exports and contain imports. Means to accomplish this were suggested by mercantilists.

3.3 Views of Physiocracy on International Trade.

Around 1770 & 1775, French economists brought about a new economic thinking termed Physiocracy. They claimed that activities that produced material surplus only can be considered productive. Agriculture was considered productive by them and all other activities non productive. International trade was non productive as both parties exchanged equal values & there was no surplus. A small surplus can arise, they claimed, only if one party was weak and accepted lesser value in this exchange.

Mercantilists prescribed import duty, since it is borne by the foreign exporter, to reduce imports & preserve gold stock. French economists brought out the fallacy in this argument by proving that when demand for imported item is inelastic price of imports would be increased without affecting

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volumes and duty burden would be borne by domestic consumers.

3.4 Adam Smith's Theory of Absolute Cost Difference

The theory is based on several assumptions like
1. Labour is the only factor of production. 2. There is full employment. 3. Perfect mobility of labour within a country and zero mobility between two countries. 4. Operation of law of constant returns.5. There are only two countries trading only two commodities.
Based on these assumptions, Smith stated that exchange of goods will take place, if each of two countries can produce a commodity at an absolutely lower labour cost of production than the other country.

3.5 Ricardo's Theory of Comparative Cost Advantage

According to Smith absolute cost difference was required for trade to take place between two countries. Ricardo proved that, if there is even a comparative difference, still trade can take place. Causes for the cost difference are provision of special facilities by nature; different human facilities in the form of physique, mental endowments, scientific and rational mind, spirit of enterprise etc.; legacy of the past, traditionally high levels of intelligence and education or uneven distribution of population.

3.6 Assumptions of the Classical [Ricardian] Theory of IT

The theory had all unrealistic assumptions as in the case of traditional theory related to one factor of production, two commodities, two countries, perfect and zero mobility etc.

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3.7 Criticism of the Classical [Ricardian] Theory of IT

The assumptions regarding one factor of production, two commodities, two countries, perfect and zero mobility, no transport costs, law of constant returns, absence of import restrictions were all unrealistic & the theory is based on all of them.

3.8 J S Mill's Theory of Reciprocal Demand

It is true that the possible range of barter terms is given by the respective domestic terms of trade as set by comparative cost advantage in each country. Within this range, the actual terms of trade will depend on intensity of each country's demand for other country's produce. And finally, states Mill, those terms will be stable at which exports offered by a country will be sufficient to pay for its imports

Mill's theory is based on the assumptions similar to those used by Ricardo. As such it is subject to same criticism as leveled against the classical theory of IT.

The End!

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