

TOPIC: CLASSICAL THEORY OF INTERNATIONAL TRADE

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Theories of International Trade

International trade theories are simply different theories to explain international trade. Trade is the concept of exchanging goods and services between two people or entities. International trade is then the concept of this exchange between people or entities in two different countries.

Classical theories

The classical theory implies that every complex concept has a classical analysis, where a classical analysis of a concept is a proposition giving metaphysically necessary and jointly sufficient conditions for being in the extension across possible worlds for that concept.

Classical theory of International Trade

Introduction

Trade is the concept of exchanging goods and services between entities. International trade, thus, means the concept of exchange between two separate countries. Entities trade because they believe that they will benefit from such a trade/exchange. In other words, this seems like a very simple concept, but in reality, it has many procedures in terms of theory, policy, and business strategies. In this article, we shall discuss the theories of International trade, especially the classical theory.

The concept of international trade emerged as a sub-part of economic study that deals with the patterns, causes, and effects of global trade. Since the 18th century, the topic has been debated to assess its effect and consequences.

Adam Smith's theory of Absolute Advantage

Absolute advantage theory is a concept developed by Adam Smith in the 18th century. The concept suggests that absolute advantage can make sizeable financial gains from the trading activities between producers of different goods or services that have different absolute advantages.

Absolute Advantage

Absolute advantage is the ability of an individual, company, region, or country to produce a greater quantity of a good or service with the same quantity of inputs per unit of time, or to produce the same quantity of a good or service per unit of time using a lesser quantity of inputs, than its competitors.

Absolute advantage can be accomplished by creating the good or service at a lower absolute cost per unit using a smaller number of inputs, or by a more efficient process.

Understanding Absolute Advantage

The concept of absolute advantage was developed by 18th-century economist Adam Smith in his book *The Wealth of Nations* to show how countries can gain from trade by specializing in producing and exporting the goods that they can produce more efficiently than other countries. Countries with an absolute advantage can decide to specialize in producing and selling a specific good or service and use the generated funds to purchase goods and services from other countries.

Ricardo's Theory of International Trade

Comparative Cost Advantage theory Comparative Cost Advantage Theory The Comparative Cost Advantage Theory of Trade was developed by British political economist, David Ricardo in his book “*The Principles of Political Economy and Taxation*” published in 1817. According to Comparative Advantage Theory, a country has a comparative advantage if it can produce a good at a lower opportunity cost than another country. A lower opportunity cost means it has to forego less of other goods in order to produce it.

Assumptions of the Theory

The theory of comparative cost advantage is based on several assumptions:

- (a) Trade takes place between two countries only, say England and Portugal.
- (b) They are trading with only two commodities, say, Cloth and Wine.
- (c) The cost of production of these two goods in both the countries is expressed in terms of labour only.
- (d) The production of these two goods in both the countries taken place at constant costs.
- (e) There is no transport cost, or the transport cost, if any, is so small a part of product prices that it is ignored.

Criticisms of the Theory As with many other economic ideas there are criticisms to be leveled at comparative cost advantage theory:

(i) It is much more complicated in the real world in deciding in which goods countries have a comparative cost advantage. This is so because there are a large number of goods and many countries.

(ii) The theory ignores the effects of transport costs. However, once transport costs are added any comparative advantage may be lost.

(iii) Modern theories, no longer based on Ricardo's labour theory, have established that the only necessary condition for the possibility of gains from trade is that price ratios should differ between countries.

(iv) Ricardo ignored the role of demand completely and explained trade from supply side.

(v) Ricardo's analysis is based on the labour theory of value as costs are expressed in terms of labour hours. However, the classical labour theory itself has lost its relevance.

(vi) The theory applied their principle in case of trade with two countries only and with two commodities only. So, the principle has a limited scope of application in practice. It cannot explain multi-lateral trade.

Different theories of international trade

One of the earliest subfields of economic theory is that of global trade and commercial policy. Government officials, thinkers, and economists have debated the factors that influence international trade from the time of the ancient Greeks to the present.

Since the time of **Greek philosophers**, the only tension in international trade has been that domestic businesses, workers, and the economy will be affected by foreign competition.

Philosophers analyse the gains from such trade and compare them to the losses of domestic business, thus comparing them to the conclusion of such trade.

The tensions caused by this dual perspective on trade have never been resolved. The theories of International trade are –

1. Classic or country-based theory of International Trade

The classical theory of trade states that goods are exchanged against one another according to the relative amounts of labour embodied in them. It is based on the labour cost

theory of value. Goods that have equal prices embody equal amounts of labour. The classic or country-based international trade theory has the following division –

- The **Mercantilism theory** was developed in the 16th century, and it was one of the earliest efforts to develop an economic theory.
- The **Absolute Cost Advantage** was introduced in 1776 by economist Adam Smith. He questioned the leading mercantile theory of the time in his publishing – The Wealth of Nations.
- The **Comparative Cost Advantage** challenged the absolute advantage theory that some countries may be better at producing both goods and, therefore, have an advantage in many areas.
- The **Heckscher-Ohlin theory** introduced by Smith and Ricardo didn't help countries determine which products would give a country an advantage. Both theories assumed that free and open markets would lead countries and producers to determine which goods they could produce more efficiently.

2. Modern or firm-based theory of International Trade

The modern or firm-based theory emerged after World War II. It evolved with the growth of multinational firms and their expansion. The theory incorporates other products and factors like customer loyalty and technology. The modern or firm-based theory of International trade has the following theories –

- **Country similarity theory** was given by Swedish economist Steffan Linder in 1961, as he tried to explain the concept of in-train industry trade. His theory proposed that consumers in countries that are in the same or similar stages of development would have similar preferences.
- The **Product life cycle theory** by Raymond Vernon, a Harvard Business School professor, developed the product life cycle theory in the 1960s. The theory, originating in the field of marketing, states that a product's life cycle has three distinct stages namely new product, maturing product, and standardised product.
- **Global strategic rivalry theory** was introduced in the 1980s and was based on the work of economists Paul Krugman and Kelvin Lancaster. Their theory focused on multinational companies and their efforts to gain a competitive advantage against other global firms in the same field.

- Porter's National **Competitive Advantage Theory** was part of the continuing evolution of international trade theories, Michael Porter of Harvard Business School developed a new model in 1990 to explain national competitive advantage. His theory stated that a nation's competitiveness in an industry depends on the capacity of the industry to innovate and upgrade.

Heckscher-Ohlin theory

This theory is also known as factor proportion theory. Heckscher and Ohlin in the 1900s, dealt with the concept of advantages that a country can gain by producing those goods on the basis of factors that are present in abundance in their country.

The main basis of this theory was the production factors of a country, like land, labour, and capital. They stated that the cost of any factor of production depended on supply and demand.

For example, China and India have cheap labour and they have become the locations for labour intensive industries. This theory explains that there is an imbalance in resources throughout the world, and thus nations should export the resources that they have in abundance. In the production of *both* products, specialization and trade could still occur between two countries.

International trade and Factor Mobility Theory

Factor mobility concerns the free movement of factors of production, such as labor and capital, across national borders. Capital is the most mobile of all. Capital is primarily transferred because of differences in expected returns, but firms may also respond to government incentives. Factor mobility refers to the ability to move factors of production—labor, capital, or land—out of one production process into another.

Factor mobility may involve the movement of factors between firms within an industry, as when one steel plant closes but sells its production equipment to another steel firm. Mobility may involve the movement of factors across industries within a country, as when a worker leaves employment at a textile firm and begins work at an automobile factory.

Finally, mobility may involve the movement of factors between countries either within industries or across industries, as when a farm worker migrates to another country or when a factory is moved abroad.