THEORIES OF INTERNATIONAL TRADE

The classical theory of International Trade responds the question that why in trade relations among different countries should be established? There are two versions of classical theory:

1. Theory of Absolute Advantage:

Absolute advantage Idea was developed by Adam Smith who was of the opinion that a tailor does not make his shoes but exchanges a suit for it, and so both tailor and cobbler gain by trading, similarly, a country would gain by having its trade relation with other countries. Smith argues that if one country has absolute advantage in one line of production over the other and the other country may have absolute advantage in the other line of production over the first. In this manner, both the countries would gain by trading. The following table illustrates the absolute advantage:

Country	Clothing	Food
X	3 units	2 units
Y	4 units	1 unit

According to the table country X has absolute advantage for the production of food over country Y because 1 worker in country X produces 2 units of food while it is only one unit in country. Similarly, Country Y has absolute advantage for clothing over country X. When international trade relations establish country X will specialised for the production of food and country Y for the production of clothing.

2. Theory of Comparative Advantage:

David Ricardo agreed completely with the idea propounded by Adam Smith that international trade would be mutual benefits of if one country has absolute advantage over the other in one line of production, and the other has absolute advantage over the first country in the other line of production, but Ricardo added a new idea and argued that even a country, having absolute advantage for both the lines of production, will be cultivating trade benefits if it specialises itself only for one of the two production lines which it can produce comparatively at lower cost of production. Comparative advantage principle will be workable only when the extent of absolute advantage is different in both the goods in question. In other words, compartment advantage should be greater in respect of one commodity than in that of the other it means nothing but the comparative difference in the cost.

Principle of comparative advantage can be illustrated by the following table giving 2 countries 2 goods model:

Country	Clothing	Food
X	6 units	3 units
Y	4 units	1 unit

According to the table, country X has absolute advantage in the production of both the goods. In the bottom row, one labourer of country Y can produce either 4 units of clothing or 1 unit of food. Thus the opportunity cost of 1 unit of food is 4 units of clothing. In the above row of table, one worker of country X can produce either 6 units of clothing or 3 units of food. The opportunity cost of food in country X is, therefore, 6/3 = 2 units of clothing, since the opportunity cost of food in country X is less than that in country Y, country X has comparative advantage in food and specialise in this good.

For confirming that this specialisation increases total world output, again suppose that each country is initially producing good both goods. Now as soon they begin to specialize: Country X switches 1 worker out of clothing and into food, and country Y switches 2 workers out of food and into clothing. Then:

Country	Clothing Output Changes By	Food Output Changes By
X	-6	3
Y	8	-2
Total *	2	1

* Therefore, the net world output increased by 2 units in clothing and 1 unit in food.

Therefore a country's comparative advantage is the good that it can produce relatively cheap, that is at lower opportunity cost then its trading partner.

Assumptions of Comparative Advantage:

The theory of comparative advantage (costs) is based on the following assumptions:

(a) This theory assumes that there is only ***one factor of production: labour***. Therefore, only labour cost incurs.

(b) The ***factors of production are perfectly immobile*** between the countries but are mobile within the country.

(c) This theory is based on the ***quantity theory of money*** because it assumes, if a country receives more money for its goods that it pays, the price level then go up.

(d) The ***cost ratio between the two goods*** in question ***remains constant*** since the production is subject to the law of constant returns.

(e) ***Trade*** between the two countries ***is free from all restrictions.***

Criticism on Comparative Advantage:

The theory of comparative advantage has been criticised seriously and rejected on the basis that it has been developed on the non-realistic and false assumptions. Nevertheless, theory of comparative costs is valid to the extent of cost differences.

Advantages:

The following advantages can be cultivated through international trade relations:

(a) The ***prices of similar goods in the trading countries***, due to international trade, ***tend to equalise*** to a greater extent.

(b) ***International trade equalizes*** also the ***distribution of scarce materials*** on global basis.

(c) Since the international trade ***equalises*** the commodity prices in the trading countries, obviously, it will not be possible without equalising ***factors prices*** in the countries in question.

(d) International division of labour and specialisation is of mutual benefits of the trading countries. ***Optimum utilisation of resources*** is possible only through international trade.

Source: Saeed Ahmed Siddiqui