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TOPIC:- THE CLASSICAL THEORY OF INTERNATIONAL TRADE

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The classical theory of international trade is also known as the theory of comparative costs or advantage. It was propounded by Prof. David Ricardo in 1815.

The classical approach basically seeks to explain how and why countries gain by trading. The idea of comparative costs advantage is drawn in view of deficiencies observed by Ricardo in Adam Smith's principles of absolute cost advantage in explaining territorial specialisation as a basis for international trade.

Prof. Ricardo stated a theorem that, other things being equal, a country tends to specialise in and export those commodities in the production of which it has maximum comparative cost advantage or minimum comparative disadvantage. The country's imports will be of goods having relatively less comparative cost advantage or greater disadvantage as well.

Assumptions of Ricardian theorem:-

For explaining the theory of comparative cost advantage, Ricardo made a two-country, two-commodity but one-factor model with the following assumptions:-

(1) Labour is the only productive factor.

(2) Costs of production are measured in terms of the labour units involved.

(3) Labour is perfectly mobile within a country but immobile internationally.
(4) Labour is homogeneous.
(5) There is unrestricted or free trade.
(6) There are constant returns to scale.
(7) There is full employment equilibrium.
(8) There is perfect competition.

Critical analysis of theory of Comparative Costs:-

Although, this theory bears a perfect logical structure, some of economists like Ohlin and Graham have put some critical analysis of this theory. Following are the criticisms of the theory of Comparative Costs:-

(I) The theory is stated in terms of the labour cost only:-

As the theory of comparative costs is based on the labour theory of value, the other factors of production are ignored in terms of their values. Hence critics assert that it is not the labour cost but money cost alone that can serve as the basis of comparison.

(II) The Ricardian theory of Comparative Costs based on the labour theory of value which itself is unrealistic:-

The Austrian School discarded the labour cost theory of value putting forth the concept of utility and marginal utility in value theory. It goes without saying that when we discard the labour theory, the classical theory of international trade is shattered to pieces.

(III) The Ricardian theory wrongly assumes labour as a homogeneous factor :-

Critics pointed out that in the comparative costs principle, homogeneity of labour is an implicit assumption. But labour is not a homogeneous factor. Hence, the classical comparative costs theory seems defective in its base.

(IV) The theory is based on constant returns to scale :-

As the theory is based on constant returns to scale, the costs of production of both the countries are the same. In actual practice, it seems unrealistic.

(V) The theory of comparative costs is based on the unrealistic assumption of full employment condition of equilibrium.

(VI) The Ricardian theory of comparative costs ignores transport cost differences.

(VII) Ricardo uses a restrictive model.

(VIII) It is only a supply-side theory.

(IX) This theory is based on the concept of free trade.

(X) The theory is based on unrealistic assumptions of the perfect mobility.

(XI) Prof. Ohlin remarked this theory as a clumsy and dangerous tool of analysis.