2 The Evolution of International Trade Theory

Trade will open up between two formerly autarkic economies if differences in production conditions warrant a profitable exchange of goods under the ruling terms of trade. In particular, a firm will decide to export its product \( x \) when the domestic price is lower than the international one.

\[
p_x < P_x
\]  

Torrens (1808) and Ricardo (1821) developed this commonsense proposition into a general theory of comparative advantage. Even if domestic costs of production in all lines of production are higher than the international ones, it pays to export if the costs of production are not uniformly higher. Differently higher (or lower) costs make for comparative advantage which is expressed in different ratios of costs/prices

\[
\frac{p_x}{p_y} < \frac{P_x}{P_y}
\]  

If the international price ratio is higher than the domestic one, it is cheaper to import \( Y \) and produce domestically \( X \).

The same idea is portrayed in Figure 2.1.

In the area A, \( P_x/P_y > p_x/p_y \) and commodity \( X \) will be exported. By contrast, \( p_x/p_y > P_x/P_y \) in B and this is an import area for \( X \). At the point C, international and domestic prices are equal and there is no incentive for trade. If the line \( p_xp_y \) is uniformly above the line \( P_xP_y \), the prices of both \( X \) and \( Y \) are internationally uncompetitive. Yet, the trade will still be profitable since the slopes of the lines (representing price ratios) are different. By changing the units of measurement (exchange rate), the domestic price line may be shifted downwards to the position C where domestic and international price ratios are equal.
In the long run, trade between two countries must be balanced (the value of export is equal to the value of import, all evaluated at international prices).

\[ P_x X = P_y Y \]

The same balance may be expressed in terms of the price ratios

\[ \frac{P_x}{P_y} X = Y \quad \text{or} \quad \frac{P_y}{P_x} Y = X \]  

(2.3)

where (2.3) represents the trade transformation curve. Since international prices are given and countries and their industries are of unequal size, the complete specialization in \( X \) and/or \( Y \) are exceptions and not a rule. This is the essence of the classical theory.

Ricardo, like all classical economists, used the labour theory of value. Value was measured by costs of production and, in this case, by the diachronic labour input, since labour was the only factor of production. As the labour theory fell into disrepute, it was replaced by the utility theory of value. When it was invented, the new theory was meant to explain consumers’ behaviour that was neglected by the classical theory. It was observed that utility increases with the scarcity of goods relative to demand (except for inferior goods and habit-forming drugs). From the consumption of goods, the theory was later extended to the production of goods as well. This was, of