The realities. a major limitation of the

The classical theory of international trade, as developed by Adam Smith, Ricardo and others, assumed that, in equilibrium, relative prices of goods reflected their relative labour cost of production. They also assumed that the trading countries were on gold standard and that gold was the final means of settling international payments.

Under this system, the supply of money in a country varied in line with the inflow or outflow of gold. In addition, their analytical framework incorporated the quantity theory of money so that price level tended to be equal to the ratio of money supply and volume of trade. Such a framework of analysis ensures that there is no long term problem of either balance of trade or balance of payments. The trading economies, at the most, face short term disturbances. There is an automatic adjustment process leading to long term equilibrium. In a sense, it is an extension of a barter system within an economy to a system of barter trading between economies. Still, the classical theory is able to answer several questions and, in essence, these answers are still valid. They only need refinements and extensions to incorporate modern realities.

A major limitation of the classical theory was its use of labour theory of value. This deficiency was removed by Haberler in restating the classical theory in terms of “ opportunity costs”. This concept measures the cost of producing one item in terms of foregoing production of some other item. The theory of international trade expanded further with the contributions of Heckscher, Ohlin and others. It was able to incorporate some realities which had been left out earlier. The theory developed further to incorporate the

fact that countries do not possess identical quantities and varieties of productive resources.

Also, production technologies vary as between products and, with an expansion in international trade, can undergo further changes. The period after the Second World War witnessed a rapid transformation both within individual economies and in their mutual economic relations. And correspondingly, the theory of international trade also expanded into a full-fledged subject of International Economics of which international trade happens to be only one part. Currently, International Economics covers the entire range of international economic transactions which include not only trade in merchandise and services but also capital flows, technology flows and so on. It deals with the problems of rate of exchange, balance of payments, and issues of policy relating to tariffs, protection, free trade, investment flows, and so on. In addition, it recognizes the role of fiscal and monetary policies pursued by individual countries. Attention has also been paid to the role of multinational corporations, cartels, monetary unions, customs unions, economic unions, trade blocs, and so on, as also to the questions of non-price competition, technology flows, the role of foreign direct investment, and similar other phenomena. While older theories of international trade were based upon the ‘ price arbitrage’ approach, recent refinements and developments are trying to take into account several types of non-price variables also.