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A BRIEF HISTORY OF INTERNATIONAL TRADE THOUGHT: FROM PRE-DOCTRINAL CONTRIBUTIONS TO CONTEMPORARY NEOCLASSICAL ECONOMICS

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Competing ideas in economics

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Abstract

The present paper outlines the development of international trade thought, from the pre-doctrinal contributions of Greek philosophers and scholastic theologians, through the theories of the first schools of economic thought, and up to modern trade theories. I follow filiations of ideas in a chronological order, and show how theoretical investigation into the causes and effects of international trade - and the necessity of government intervention - has evolved over centuries of economic thought.

Keywords: international trade; history of economic thought;

Contents

Introduction

For centuries, international trade in goods and services, and the development of the international division of labor have constituted a focus point of study for economists and philosophers alike. Research in this field usually revolves around three main lines of inquiry[1]: (a) what are the causes of international trade? (b) what are the effects of international trade?, and given these two aspects, (c) is government intervention in international trade necessary or beneficial? Broadly speaking, the first two questions belong to economic theory, while the latter is concerned with economic and trade policy. Nevertheless, between the two areas there is no clear-cut separation: economic theory influences economic policy, and by the same token, political decisions and ideological trends leave an imprint on the conceptual foundations of economic theory.[2]

The present paper provides a short overview of how the answers to these three questions have evolved alongside the development of economic theory. To this end, we shall follow filiations of ideas in a chronological order, and also highlight occasionally the influence of politics on the progress of these ideas.

[1] Cf. Wu (2007 [1939]).
[2] Cf. Irwin (2002).

1. Pre-doctrinal theoretical elements

Up until the Middle Ages, philosophers and theoreticians did not undertake any systematic study of international trade. Consequently, early trade theories are fragmented, and laced with ethical and political considerations. Within this pre-doctrinal period, four subsequent periods can be delineated: Ancient Greek thought, scholastic and Christian thought, mercantilism, and Physiocracy.

1.1. Ancient Greek thought

The most important ideas of this period concerning international trade are found in the works of Plato, Xenophon, and Aristotle. Early on, these philosophers discussed the effects of the division of labor and of voluntary exchange of goods, considering them to be beneficial to both parties involved in the transaction. In 380 BC, in *The Republic*, Plato discusses the practical impossibility of self-sufficiency for a city state, given that division of labor brings about a higher productivity and higher output than autarky, allowing individuals to specialize according to their natural aptitudes and available natural resources (Plato 1930). In 340 BC, Xenophon, in following Plato, also mentions the benefits of the price arbitrage carried out by traders in search of profit, as well as the advantages of a larger market – in other words, the advantages of international trade (Xenophon 1918).

Notwithstanding these considerations, the Greeks did not declare themselves in favor of international commercial relations. As one example, in *Politics* – around 350 BC -, Aristotle argues for a certain degree of economic self-sufficiency – in fact, as high as possible – that would limit trade or any unwanted contact with foreigners (Aristotle 1932). Thus, part of the city rulers' duty was to decide which exports and imports are absolutely necessary, and furthermore, to insure the fairness of these exchanges through some type of commercial treaties with other cities.

1.2. Scholastic and Christian economic thought

Aristotelian philosophical ideas constituted the foundation for the development of scholastic and Christian thought between the 13^{th} and 15^{th} centuries. As a consequence, economic science was first born as a peripheral branch of ethics. Philosophers and theologians of this period looked upon international trade with skepticism. In principle, they agreed that the peoples and regions of the world were not endowed by nature with all the things necessary for survival, and thus that international trade was to a certain degree indispensable. However, they also viewed international trade as having alarming moral consequences. For instance, in the early 5th century, the theologian St. Augustine echoed the opinion of Greek philosophers, according to which commercial activities foster avarice and fraud – even though, unlike the Greeks, St. Augustine did not wish people to become autarchic from a cultural point of view.[3]

These prejudices continued to influence medieval scholastic thought, albeit gradually losing their importance. In *Summa Theologica* (written between 1265 and 1274), Thomas Aquinas accepted the idea that imports and exports are beneficial to society, while remaining careful in regard to the potentially bad influence of foreigners (Aquinas 1947). While material gain in itself never came to be considered virtuous or necessary, its connotations were no longer undoubtedly immoral.

The natural law philosophy that followed scholastic works of the 16th century was the first to systematically lay the foundations for commercial freedom. In 1608, Hugo Grotius proclaimed the benefits of the total freedom of international trade, freedom that no state had the right to oppose (Grotius 1916). In like manner, in 1612, Francisco Suarez wrote that making free commercial exchanges is an unalienable right of every individual, and of every nation (Suarez 1934). Consequently, respecting this right not only did not bring any economic or cultural damage, but it was in fact in the interest of the entire human society.

1.3. Mercantilism

Together with the emergence of the nation states, commercial relations became increasingly more important. It was against this background that mercantilism sprang up as a profoundly nationalist movement, reaching the peak of its popularity in 16th and 17th century England through the writings of Thomas Mun (1664) and Gerard de Malynes (1622), as well as through the protectionist policies of Jean-Baptiste Colbert in France.

Mercantilists' main concern was increasing the welfare of one's own nation, increase which – in their view – could be obtained only by decreasing the welfare of other nations. The means necessary for reaching this goal consisted in the accumulation of precious metals, i.e. gold and silver, in a country's treasury. Given the premise of a perpetual conflict among states – albeit insufficiently argued in mercantilist works – international trade was understood as a zero-sum game. Governments were thus encouraged to come to the aid of national producers, as well as promote exports of manufactured goods and imports only of raw

[3] Cf. Irwin (1997).

materials, via price controls, tariffs and other trade barriers. These policies were supposed to encourage the inflow of gold while hampering the outflow, insuring a favorable balance of trade.

Nevertheless, mercantilist trade thought gradually lost its relevance once the consistent implementation of such policies led to the economic decline of these nations, as well as due to the harsh criticism delivered by 19th century liberals.

1.4. Physiocracy

The Physiocrats can be considered as the first economic theoreticians, whose ideas preceded – and to a certain extent, influenced – the development of economic science within the British and French schools of thought.[4] According to the best-known representatives of Physiocracy – François Quesnay, A.-R.J. Turgot – the wealth of a nation depended almost exclusively on the development of the agricultural sector. Despite some remnant mercantilist ideas concerning the ideal of a favorable balance of trade, the Physiocrats argued mainly in favor of trade liberalization. In the second half of the 18th century, Turgot advocated that "all branches of commerce ought to be free, equally free, and entirely free" (Turgot 2011).

[4] Cf. Schumpeter (1954).

2. The development of international trade theory

International trade theory proper originated from the liberal reaction to the mercantilist domination from the 16th to the 18th century, a reaction which approached the topic of international trade with considerable attention. The 19th century belongs, from this point of view, to two main schools of thought: the British Classical School and the French Liberal School, whose well-known members were Adam Smith, David Ricardo, and John Stuart Mill, and Jean-Baptiste Say, Frédéric Bastiat and Paul Leroy-Beaulieu, respectively.

In addition, the 19th century marks the emergence of economics as an autonomous science, as well as the debut of the first important differences in the theories of contemporary schools of thought.

2.1. The British Classical School

Adam Smith is considered to be the founder of the School, and his best-known treatise, *The Wealth of Nations* (published in 1776), is a comprehensive and thorough critique of mercantilist thought (Smith 1954). In his work, Smith highlighted the importance of the division of labor in increasing output, and considered international trade as a particular case of specialization, i.e. international specialization among nations. According to Smith, in a world of scarce resources and unlimited wants, every country is bound to specialize in the production of those goods that can be produced at a lower absolute cost, i.e. fewer hours of labor. These goods, in turn, will be exchanged for the goods for which other countries have an *absolute advantage* in production. Smith's ideas were later developed and enriched by David Ricardo in 1817, who first described the principle of *comparative advantage* within the same labor theory of value: countries should specialize in producing those goods which require – in relative, not absolute terms – a lower cost, i.e. relatively less hours of labor (Ricardo 1821).

For both Smith and Ricardo, cooperation among nations was considered a positive-sum game, international exchanges being mutually beneficial for all countries. After 1848, with John Stuart Mill and the *theory of international values*, the accent was shifted to a fixed-sum game: the concept of *terms of trade* – which depend on the intensity of reciprocal demand for goods – came to explain the share of each country in the total benefits of international trade (Mill 1909). Unsurprisingly, this new direction in economic theory raised new questions in the field of trade policy: how could a nation acquire a larger share of the total gains from trade? Hence, governments' protectionist policies were once more given a green light by theoreticians.[5]

Last but not least, the theories put forth by these British economists marked the evolution of economic science – and of international trade theory – for centuries to come. Ricardo set the foundation for aggregate general-equilibrium analysis, and diverted economic analysis toward the separation between the "real" economy – of goods and services – and the "monetary" economy, a separation also known as the *classical dichotomy*. Similarly, John Stuart Mill divided the theory of value into principles applicable to domestic trade, and those applicable to international trade, i.e. the theory of international values.

2.2. The French Liberal School

Jean-Baptiste Say, the founder of the French Liberal School, declared himself from the very beginning an opponent of the economic analysis developed by Ricardo and Mill, even though the French economists shared the same ideals of economic and trade freedom as their British counterparts. First of all, Say, Bastiat, Leroy-Beaulieu, and Courcelle-Seneuil were vehement critics of the labor theory of value and of the classical dichotomy, considering both concepts to be erroneous (Courcelle-Seneuil 1858; Leroy-Beaulieu 1914; Say 1971; Bastiat 2007). Second, these French economists claimed that the same economic principles underlie both domestic and international trade, and thus, that a theory of international values has no theoretical justification. Their works contain therefore an integrated approach to international trade, both real and monetary, as well as elements of a rudimentary subjective theory of value. The French economists focused on a microeconomic analysis of international trade, explaining the role of entrepreneurial activity and its benefits for individuals and society in general.

Nonetheless, the French economists lost the popularity battle with the British Classical School. General equilibrium analysis and the classical dichotomy became standard methods within the 20th century neoclassical economics paradigm, and international trade became almost exclusively the subject of macroeconomic, aggregated analysis, with no role for entrepreneurial activity.

[5] Cf. Viner (1937).

3. The paradigm shift: the marginalist revolution

At the end of the 19th century, the labor theory of value was replaced by the subjective theory of value, developed in the works of Carl Menger (2007) and Stanley Jevons (1888) - both treatises originally published in 1871 -, and Léon Walras (1926), whose treatise was originally published in 1874. Following this turning point in economic science, and against the background of intensifying commercial relations among nations, the development of international economics as a special branch has been spectacular.

For the first part of the 20th century, neoclassical theories have formalized, elaborated, or criticized the principle of comparative advantage, framing it within the new subjective paradigm. In 1895, in his article *Mathematical Theory of International Trade,* Vilfredo Pareto created the first mathematical model of Ricardo's principle, for two countries and two goods. In this model, relative costs were expressed in terms of marginal utility, in the attempt to eliminate the labor theory of value from the principle of comparative advantage (Pareto 1985). In like manner, Gottfried Haberler formulated in 1935 the principle of comparative advantage in terms of opportunity costs rather than hours of labor. Pareto and Haberler's explanations opened the gate for mathematical models with multiple countries and multiple goods, and set the conceptual foundations for modern trade theory. Furthermore, these contributions managed to keep alive the principles of commercial freedom, which in the war-ridden Europe of the early 20th century had already begun to fade.

The Swedish economist Bertil Ohlin, inspired by his professor Eli Heckscher (1919), developed the *theory of factor endowments* in his 1933 treatise, later revised in 1967. Unlike Pareto and Haberler, Ohlin wished to discard Ricardo's theory completely, and replace it with his own new explanation of international trade: given two factors of production, labor and capital, Ohlin proposed that countries relatively more endowed in capital should produce and export capital-intensive goods, thus specializing in those sectors which use the factor of production the country is relatively more endowed with. Albeit contradicted by some empirical studies of international trade flows, Ohlin's contribution is still considered to be a correct and detailed theoretical explanation of the causes of comparative advantage, easily reconcilable with Ricardo's principle.[6]

Even though the 20th century has been marked in an overwhelming proportion by the development of neoclassical economics on the basis of the works of 19th century British economists, the ideas of the French

[6]Cf. Maneschi (1998).

liberals have not been entirely forgotten. Ludwig von Mises shared many of the views of his French intellectual predecessors, and his work is largely an endeavor to discard the overarching classical dichotomy, and to reconcile real and monetary economic analysis. Moreover, Mises reinstated entrepreneurs in their central role in the economy: he highlighted the importance of the correct entrepreneurial allocation of economic resources nationally and internationally, as well as the role of monetary prices in this process.

Consequently, in *Human Action* (1998 [1949]), Mises set forth the *Ricardian law of association,* a general law of economic cooperation, of which country specialization is simply a particular case. This contribution emphasized once again that the same principles underlie both domestic and international trade; it showed once more that the benefits of the division of labor spring from differences in the productivity of resources, but highlighted also the importance of individual rational decisions to engage voluntarily in exchanges. In addition, Mises emphasized that relative costs are meaningful only as monetary costs, determined by the market process that brings about the structure of prices, thus bringing together the basic principles of international trade theory and those of monetary theory.

4. Modern and contemporary trade theories

As we have seen above, classical trade thought was assimilated into neoclassical theory through mathematical models, whose purpose soon became that of predicting international trade flows and possible welfare increases. Subsequently, neoclassical trade theory focused on polishing and perfecting these models, on correcting some errors (like the perfect competition hypothesis) and on extending these models to incorporate more and more variables (technological development, scale economies, product life-cycle theories). Because the second half of the 20th century had its fair share of turning points in economic science, the theoretical corpus became increasingly heterogeneous.

Paul Samuelson is considered to be the founder of modern economics, the scholar who set the foundation for the synthesis between neoclassical economics and John Maynard Keynes's theoretical system. These new, synthesized principles were soon applied to international trade as well, giving rise to contributions such as the *Balassa-Samuelson theorem* (1964) and the *Stopler-Samuelson effect* (1941). The former refers to the purchasing power parity, which is influenced by the relative productivity of sectors that produce tradable and non-tradable goods. The Stopler-Samuelson effect focuses on the relationship between the relative prices of finished goods and those of the factors of production. Both contributions have also opened the way for new trade policies, tailored to stimulate the productivity of certain economic sectors depending on their influence on the purchasing power of a currency, or on the terms of trade.

A student of Samuelson, Paul Krugman, developed in the early 1980s the *New Trade Theory*, starting from the assumption that neither comparative advantage nor factor endowments are satisfactory explanations for international trade flows, especially not for intra-industry trade flows. Hence, Krugman (1979) shifted his attention to the role of scale economies, showing that given consumers' love of variety and the increased efficiency in production, countries specialize in producing a small number of brands of the same product rather than a group of different products. On these trade models with monopolistic competition, Brander and Spencer (1985) developed soon after the *strategic trade policy* theory, positing that countries could increase welfare by transferring the profit of foreign firms onto national firms. The strategic use of export subsidies, research and development investments, as well as trade barriers – albeit bearing the risk of retaliation – can come to the rescue of national companies, helping them develop and conquer international markets.

Also in the early 1980s, the Neo-Ricardian School of Piero Sraffa (1960) and Ian Steedman (1979) emerged as a reaction to the great development of neoclassical trade theory. Much less influential than their opponents, Straffa and Steedman focused on reshaping Ricardo's theory by keeping the labor theory of value and rejecting the marginalist revolution. One purpose of their research was to show how international trade has negative consequences on the less developed nations of the world. Finally, over the past few decades, the Austrian school has brought back to light the contributions of Ludwig von Mises to international economics, further polishing the Ricardian law of association and criticizing new developments in mainstream trade theory. American economists such as Murray Rothbard (1995) and Joseph Salerno (1990) have also revived the French liberal tradition, and the contributions of Turgot, Say and Bastiat.

5. Conclusion

The field of international trade, in its theoretical – as well as political – aspects, suffered significant modifications over the course of the 20^{th} century. New schools of thought (Keynesian, monetarist, heterodox), as well as new political and ideological trends (i.a. sustainable development, environmentalism) have all left their imprint on this branch of economics. Trade theory is nowadays a fragmented, heterogeneous theoretical corpus, which focuses more on details, and less on the big picture.

On the other hand, in the sphere of trade policy, free trade no longer means what it used to in the pre-1914 *laissez-faire* era, and a *new mercantilism* is on the rise: especially after the military conflicts of past decades, planned international trade is once more on all governments' agendas. In this context, economic theory cannot avoid informing decision-makers of the consequences of changing the natural course of international cooperation.

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1. *Annex: A Brief History of International Trade Thought*

Pre-doctrinal theoretical elements

- Ancient Greek thought
- Scholastic and Christian economic thought
- Mercantilism
- Physiocracy

The development of international trade theory

- **The British Classical School**
  - Adam Smith (1776)
  - David Ricardo (1817)
  - John Stuart Mill (1848)
- **The French Liberal School**
  - Jean-Baptiste Say (1803)
  - Frederic Bastiat (1845)
  - Paul Leroy-Beaulieu (1881)

The paradigm shift: the marginalist revolution

- Vilfredo Pareto (1894)
- Eli Heckscher (1919)
- Bertil Ohlin (1933)
- Gotfried Haberler (1935)
- Ludwig von Mises (1949)

Modern and contemporary theories

- Neoclassical School
- Neo-Ricardian School
- Austrian School