A Note on Adam Smith and International Trade

Wontack Hong*

<Contents>

I. Introduction

Textbooks on international trade such as those by Takayama [18] and by Caves and Jones [4] err in beginning their account of the development of trade theory with Ricardo, giving Adam Smith at most a passing reference on absolute advantage.(1) Smith's contribution of a theory of gains from trade based on increasing returns to scale is ignored not only in Chipman's survey [5] of the classical theory of trade but also in the surveys by Haberler [10] and by Bhagwati [1]. An objective of this note is to offer direct advice on the contents of new textbooks on international trade that Adam Smith must be introduced, not from the viewpoint of absolute advantage, but from the viewpoint of his emphasis on the relation between trade and scale economies.

---

* The author is Professor of International Economics, Seoul National University.

(1) Caves [3] says that "Classical international trade theory was concerned first of all with the gains from trade,… a general model of trade and production has arisen directly from the insights of Ricardo and Mill." Consequently, Caves and Jones [4] state that "David Ricardo's name is associated with the earliest model of trade," and Adam Smith never appears in their book.

II. Smith and Absolute Advantage

Viner [19, pp. 439-440] argued that "In the beginning of free trade doctrine in the eighteenth century the usual economic argument for free trade were based on the advantage of a country of importing in exchange for native products, those commodities which either could not be produced at home at all or could be produced at home only at costs absolutely greater than those at which they could be produced abroad... The case for free trade as presented by Adam Smith did not advance beyond this point." In this fashion, all the textbooks on international trade either completely ignore the contribution of Adam Smith on the theory of international trade or, by quoting a paragraph or two from "On Foreign Trade" in Smith [16, pp. 424-6], begin with a slighting assertion that Smith attributed gains from trade to the existence of "absolute advantages" in producing some commodity in every country.

For instance, Kindleberger and Lindert [11, p. 17] quote the following paragraph from Smith[16, pp. 424-425]:

> "It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his own shoes, but buys them from the shoemaker... What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which have some advantage."

Since the idea that two countries can gain by trading if one country has an absolute advantage over the other country in one line of production and the other country has an absolute advantage over the first country in another line of production sounds too obvious to be called a theory, all texbooks introduce Ricardo as the first economist to make an original contribution to the theory of international trade.

Takayama [18, p. 109] argues that, although "free trade and free competition were the economic content of laissez faire" and Adam Smith strongly attacked mercantilism, Ricardo "attempted the first rigorous theoretical justification of free trade". Takayama [18, p. 113] goes on:

> "Adam Smith stumbled on absolute advantage and concluded that international trade could not occur between the countries if one country was definitely superior to the other in the production of all the goods. Ricardo's genius revealed the mistake in this rather appealing logic by simply comparing the relative efficiency of the countries in the production of each good."

The sad fact is that the textbook writers do not care about accurately representing Smith. They only care about communicating the rudiments of absolute advantage and comparative advantage to their students.

III. Non-Textbook Literature

The available non-textbook literature on Adam Smith seems to suggest that such cavalier treatments of Smith must have resulted either from a myopic and extremely shallow interpretation of Smith or from a careless and secondhand reading of *The Wealth of Nations* by the textbook writers. Smith's theory of trade has received much admiring attention from recent writers in the history of economic thought such as Bloomfield [2], O'Brien [14] and Myint [13]. O'Brien [14, pp. 170 & 172] states that:

> "The classical theory of international trade essentially grew out of the work of Adam Smith—from that *locus classicus* of the free-trade doctrine, *The Wealth of Nations* ...Having given all due weight to these earlier writers, there still seems no reason to doubt the verdict that classical trade theory, and the modern trade theory which is essentially descended from it, stem directly from Adam Smith...What trade does is to widen this market, so increasing the scope for division of labour." "Freedom of trade also ensured that capital flowed to those employments where it would be most productive in increasing the division of labour. This was the message in *The Wealth of Nations*; and this message, and indeed the very phrases in which it was written, found constant repetition in the classical works."

Myint [13] states that "Smith applied his fundamental principle that 'division of labor is limited by the extent of market' to all levels of economic activity... The same mode of analysis is extended to the trade between the inhabitants of the towns and the country." However, in appraising Smith's stature as an international trade theorist, Myint seems to have gone a little bit too far. Myint argues that Smith's trade theory "is not based simply on the static principle of the efficient allocation of the given resources. Rather, Smith would regard free trade as a method of bringing out more fully the longer-run productive potentialities of countries..." According to Myint, the most important contribution of Smith was "the study of the long-run mutual interaction between foreign trade and domestic economic development," and yet "this still remains one of the major unsettled questions of modern international trade theory." That is, according to Myint, Smith could not countribute any conclusive and settled theory for international trade. Myint derives two essential ideas from *The Wealth of Nations*:

> "(i) By widening the extent of the market, international trade improves the division of labor and raises the general level of productivity of resources within the country. This may be called the 'productivity' theory. (ii) By widening the extent of the market, international trade provides a market outlet 'for whatever part of the produce of their labour may exceed the home consumption.' This contains the germ of the 'vent-for-surplus' theory."

Myint seems to have emphasized the second idea too excessively which led him, quite unintentionally, to conclude that Smith only raised an important question that "still remains one of the unsettled issues of modern international theory." Had he emphasized the first idea, however, Smith's contribution to trade theory could have been viewed more definitive.(2)

(2) It may be argued that, according to the Smith's theory based on scale economies, it should be almost by pure accident that a country gets specialized in some specific line of production, and hence there is no way to predict the patterns of production and trade that may emerge among different countries while, in contrast, it might be argued that Ricardian model or Hecksher-Ohlin model enables us to predict the pattern of production and trade of each country more precisely. For that fundamental matter of precise prediction, however, one has yet

IV. Importance of Increasing Returns to Scale

Södersten [17, p. 85] argues that increasing returns to scale can be an "interesting" source of trade without even mentioning Smith:

"The man in the street, if he reflects on the causes of trade, would probably say that international specialization is due to the fact that unit costs of production fall as the scale of production increases. In particular, small countries should be able to benefit from international trade if increasing returns to scale are present. As it is no longer confined to small scale production of its exportables, it can increase capacity and lower production cost. Before European integration European unit costs were usually distinctly higher than U.S. costs for the same product. This has been explained by the fact that the average European plant was producing more ranges, styles and sizes than its American counterpart. An increase in the length of run made possible by increased exports can then have important cost-reducing effects."

Dixit and Norman [7] begins the last chapter of their textbook saying that "it is well-known and fairly obvious that scale economies create potential gains from trade... it simply reflects Adam Smith's observation that the division of labor is limited by the extent of the market." Then they devote the chapter for the study of "scale economies and imperfect competition" making the following introductory statements:

"...the large volume of intra-industry trade—estimated at 50% of world trade by Grubel and Lloyd [9]—can only be understood within the context of product differentiation and economies of scale...Perfect competition is in general incompatible with economies of scale, so some form of imperfect competition will prevail...will trade, by expanding the total market, increase competition and thus reduce monopolistic distortions? The set answer is yes. The implication is that there should be a double gain from trade: it should result in longer production runs and thus lower average cost, and it should reduce mark-ups of price over marginal cost."

However, according to Dixit and Norman, the theory of international trade

---

to explain why a country should have the relatively superior technology of production in any specific line of manufacturing or should be endowed relatively abundantly with, say, capital.

implies the theory of comparative advantage and the theory of terms of trade. According to them, Smith simply provided "an observation" and no theory for international trade.

Samuelson [15] had already pointed out that Ohlin, more than almost any other writer, "has followed the lead of Adam Smith and made 'increasing returns' an important cause for trade." According to Samuelson, it is true that increasing returns to scale may create difficulties for the survival of perfect competition. But these difficulties cannot always be sidestepped by pretending that the increasing returns are due primarily to external rather than internal economies. Furthermore, these difficulties do not give us the right to deny or neglect the importance of scale factors. Anyway, if demand becomes large enough, production may be carried into the realm of constant returns to scale. Increasing the "extent of the market" not only increases specialization, but it also increases the possibility of viable pure competition.(3)

V. First Chapter for International Trade Textbook

According to Smith[16, p. 19], any two countries can, by carrying on commerce with each other, and "by mutually affording a market, give a good deal of encouragement to each other's industry".

> "By means of it, the narrowness of the home market does not hinder the division of labour in any particular branch of art or manufacture from being carried to the highest perfection. By opening a more extensive market for whatever part of the produce of their labour may exceed the home consumption, it encourages them to improve its productive powers, and to augment its annual produce to the utmost, and thereby to increase the real revenue and wealth of the society". (Smith [16, p. 415])

(3) One of the important economic rationalizations for EEC is based on the scale economies. Writing in 1955, Gehrels and Johnson [8] argued that there were unexploited economies of mass production in Europe: American productivity is higher than U.K. productivity for most commodities but the differencial is greatest in those industries which use mass-production methods. (See also Lipsey [12].) According to Corden [6], one may expect an increase in welfare of European countries due to the reduction in the average cost upon the formation of EEC which is the result not of a (Ricardian) movement to a cheaper source of supply but rather of the (Smith's) cheapening of an existing source of supply.

If we can conclude that one of the most important contributions of Adam Smith on economic thinking was his emphasis of the increasing returns to scale based on division of labor and specialization, whose benefit is limited by the extent of the market, we can now further say that Smith explained the gains from trade on the basis of nothing but the increasing returns to scale. Then what Ricardo had demonstrated is that the gains from trade can arise "even in the absence of" increasing returns to scale if there are differences in the relative costs of production. Hence the arguments of Smith and Ricardo supplement each other, filling up the gaps between the available theories and the real world.

Therefore, Adam Smith must be introduced in the first chapter of international trade textbooks and furthermore must be presented, not from the viewpoint of absolute advantage, but from the viewpoint of increasing returns to scale.

References

〔1〕 Bhagwati, Jagdish, "The Pure Theory of International Trade: A Survey," in *Surveys of Economic Theory*, prepared by American Economic Association and Royal Economic Society, London: Macmillan, 1966.

〔2〕 Bloomfield, A.I., "Adam Smith and the Theory of International Trade," in *Essays on Adam Smith*, edited by A.S. Skinner and T. Wilson, Oxford: Clarendon Press, 1975.

〔3〕 Caves, Richard E., *Trade and Economic Structure*, Cambridge: Harvard, 1963.

〔4〕 Caves, Richard E., and Ronald W.Jones, *World Trade and Payments*, 3rd edition, Boston: Little Brown, 1981.

〔5〕 Chipman, John S., "A Survey of the Theory of International Trade: Part I, The Classical Theory," *Econometrica*, July 1965.

〔6〕 Corden, W. Max, "Economies of Scale and Customs Union Theory," *Journal of Political Economy*, March 1972.

〔7〕 Dixit, Avinash K., and Victor Norman, *Theory of International Trade*, London: Cambridge, 1980.

〔8〕 Gehrels, F., and H.G.Johnson, "The Economic Gains from European Integration," *Journal of Political Economy*, August 1955.

〔9〕 Grubel, H.G., and P.J.Lloyd, *Intra-Industry Trade*, London: Macmillan, 1975.

〔10〕 Haberler, Gottfried, *A Survey of International Trade Theory*, Special Papers in International Economics, International Finance Section, Princeton University, 1961.

〔11〕 Kindleberger, Charles P., and Peter H.Lindert, *International Economics*, 6th edition, Homewood: Irwin, 1978.

〔12〕 Lipsey, R.G., "The Theory of Customs Unions: A General Survey," *Economic Journal*, September 1960.

〔13〕 Myint, H., "Adam Smith's Theory of International Trade in the Perspective of Economic Development," *Economica*, August 1977.

〔14〕 O'Brien, *The Classical Economists*, Oxford: Clarendon Press, 1975.

〔15〕 Samuelson, Paul A., "International Factor-Price Equalization Once Again," *Economic Journal*, June 1949.

〔16〕 Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776. (Page references are to the Cannan edition, New York: Modern Library, 1937.)

〔17〕 Södersten, Bo, *International Economics*, 2nd edition, London: Macmillan, 1980.

〔18〕 Takayama, Akira, *International Trade*, New York: Holt, Rinehart and Winston, 1972.

〔19〕 Viner, Jocob, *Studies in the Theory of International Trade*, New York: Harper, 1937.