Trade Basics

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Understanding the Basic Economic Principles of Trade

By Megan J. Provost

Humanity has engaged in trade, exchanging goods and services, throughout most of its existence. Originally, trade operated on the barter system; goods were traded for other goods in the absence of currency. Trade eventually became more sophisticated as mediums of exchange were developed and the practice of barter became obsolete. The invention of money (and subsequently credit, paper money, and non-physical money) greatly simplified and promoted the development of trade.

In order to understand modern trade, however, one must first understand the important and fundamental advancements in our understanding of the economic value of trade over the past several hundred years.

Mercantilism – Mercantilism was the prevailing economic theory of trade from the 16th to the late 18th century. Mercantilism consisted of two main ideas. The first idea was that precious metals determined a nation's wealth. The second idea was that countries should export more than they import. During the mercantilist age, it was often suggested that the principal benefit of foreign trade was the importation of gold and silver. According to this view, the benefits to one nation were matched by the costs to the other nations that exported gold and silver. This meant that there were no gains from trade; that trade was a "zero-sum game." Under mercantilism, many imports were prohibited and exports were often subsidized. The state would impose wage, price, and production controls. State control over the economy also extended into the creation of private monopolies, as governments gave certain individuals the legal privilege of being the single producer or seller of certain goods and services.

Absolute advantage – In 1776, in his famous work, *The Wealth of Nations*, Adam Smith refuted the idea that the wealth of a nation is measured by the size of its treasury. Smith made a number of important criticisms of mercantilist doctrine. First, he demonstrated that trade, when freely initiated, benefits both parties; that is, trade is a "positive-sum game." Second, he argued that specialization in production allows for economies of scale, improving efficiency, and promoting growth. Thus, a country should specialize in the production of goods that it produces more efficiently, or cheaper, than any other good it produces and trade for those goods it is less efficient at producing.

The publication of *The Wealth of Nations* is generally considered to mark the end of the mercantilist era. Most contemporary economists accept the idea that free trade leads to international specialization of labor and, usually, to greater economic well-being for all of the nations involved.

Comparative advantage – A significantly more complicated and counter-intuitive theory goes further in explaining why countries that excel at producing many goods can still benefit from trading with seemingly less efficient countries. In his 1817 book, *The Principles of Political Economy and Taxation*, David Ricardo explains the theory of comparative advantage. He describes a situation between two countries in which one country can produce two different goods more efficiently, or cheaper, than the other country. Ricardo points out that the welfare in both countries can still be raised by specialization and trade if one country is relatively better at making one than the other. Gains from specialization and trade can be realized by putting more resources into producing those goods that a country produces most efficiently over other goods it produces less efficiently. In other words, even if one country can produce every good more efficiently than anyone else, it can still gain by specializing in the goods it produces most efficiently. Conversely, a country does not have to be the best at anything to gain from trade.

According to the theory of comparative advantage, gains from trade come from specializing in those activities at which the country is relatively better, regardless of whether the country produces them more efficiently than another country (i.e. whether it has an absolute advantage). Thus, a country should specialize in the production of goods that it produces most efficiently, not necessarily cheapest, and trade for other goods.

Since the mid-1800s, subsequent economic theories have expanded on and qualified Ricardo's theory of comparative advantage. And, economists continue to examine to what extent comparative advantage explains the increasingly complex trade patterns in the 21st century. But, understanding these basic economic principles of trade promotes a more thoughtful discussion about global trade and the impacts that interruptions in global trade can have on economies around the world.

About the Author: Megan Provost is the Vice President of Policy and Programs at Farm Foundation. Prior to joining the Foundation, Megan worked for Dow AgroSciences, for a U.S. Senator, at the U.S. Department of Agriculture, and at the American Farm Bureau Federation. Megan has a bachelor's and master's degree in agricultural economics and a juris doctorate.