Module 2

Lecture 5

Topics

2.2 Adam Smith II

2.2.1 International Trade

2.2.2 Value theory

2.2.2.1 Relative prices

2.2.2.2 Smith on Value

Adam Smith II

2.2.1 International Trade

- A major objective of Smith's theory was to falsify mercantilist idea who thought that trade is detrimental for a country.

- The Mercantilists thought that holding a positive balance of payment is the key to economic development and hence regulated trade is important.

- Smith on the other hand the theory of absolute advantage. According to this theory if England produces wool at lower cost than France and France can produce wine at a lower cost than it is beneficial for both the countries to produce and exchange.

- He said that two individuals born with same level of talent, become more proficient by specialization and trading. This argument can be extended by learning by doing type of models.

- Unlike the popular presentation of the text book presentation of the theory of absolute advantage, we can infer elements of dynamics from Smith's trade theory. Smith postulated in case of individual labor that the dexterity of laborer increases with increasing degree of specialization. He said that productivity

differentials among individual agents were a mere result rather than the cause of the division of labor. Similarly, a country specializing in one good would gain from learning by doing "and thereby exploit increasing return through international specialization.

- Embedded in Smith's analysis is a theory of how markets develop dynamically over time.

- In essence, the classical thinkers championed the idea that trading is not a zero sum game. Hence, trading can bring gains for both the parties. This view was quite a novel approach in a period when policy makers were by and large characterized by economic nationalism. Smith countered the dominant view that trade is a zero sum game by arguing that both parties can gainfully engage in trade.

2.2.2 Value theory

- Some of the fundamental questions which stimulated early economic thinkers were

  1. What determines the price of a good?
  2. How can we compare between different types of goods (e.g. apple and hammer) so that exchange is possible? In other words, what is common in all goods that make exchange possible?
  3. What is the best measure of welfare?

- Like his contemporaries, Smith also tried to answer these questions.

2.2.2.1 Relative prices

- Following the classical tradition, Smith emphasized the role of supply side factors or cost of production as the determinant of relative prices.

- Nevertheless, he did not completely ignore the role of demand. In order to bring in demand in the picture he distinguished between long run and short run.

- In short run, both demand and supply played important roles in determining price.

- In the long run, Smith differentiated between agriculture and industry in terms of the determination of long run price.

- For agriculture, according to Smith, both downward sloping demand and upward sloping supply play role in determining long run price.

- For manufacturing, Smith held that supply can be horizontal (constant cost) or downward (decreasing cost)

- In case of horizontal supply curve price is completely supply (i.e. technology) determined while in case of downward sloping demand also plays a role in determining long run price.

- Apparently, Smith was inconsistent. However, Smith always noted the importance of demand in determining long run prices even though like other classical economists Smith's major emphasis was on cost of production for explaining relative price determination.

2.2.2.2 Smith on Value

- According to Smith, there are two types of values: use value and exchange values.

- Exchange value in Smiths formulation was easy to understand -- it's something that can buy other goods.

- Use value touched upon the concept of utility, but Smith was only concerned with total utility. The concept of marginal utility had to wait for hundred more years after Smith wrote Wealth of Nations.

- As Smith was somewhat confused about what determines relative prices he developed three different theories of value viz. (1) labor cost theory of value, (2) a labor command theory of value and (3) a cost of production theory of value.

- According to Smith, labour cost theory works in a primitive society: Through his famous deer-beaver example he explained that if it takes twice more hour to catch a beaver than hunt a deer then a beaver should cost twice more than a deer.

- However, the biggest problem with this formulation is the issue of comparing between hours of differently skilled labors.

- Smith tried to resolve the issue that wage paid to a labor captures the hardship and dexterity required for a job. Hence, relative wage captures relative labor for different jobs.

- But this argument had circularity problem -- Smith was using one set of relative prices (of labor) to explain another set of prices (of commodities).

- <u>Labor command</u> in a primitive society -- this theory is merely a direct implication of the labor cost theory. It says that a value of a good is equal to the labor required to produce it and therefore a good commands that much of another good which has same amount of labor as the original good.

- Smith recognized that the labor theory in an advanced economy has to be different from that in a primitive economy. The distinguishing features of an advanced economy are capital accumulation and private property right over land. Hence, price must reflect return to these inputs as well.

- For an advanced economy, Smith held the view that value must depend on the returns to labor, land and capital. In his view the total cost of producing a beaver is equal to wages, profits and rent: $TC_B = W_B + P_B + R_B$. Similarly for a deer, $TC_D = W_D + P_D + R_D$. The relative prices of deer and beaver will be given by TC_D/TC_B. Where Smith assumed that average costs are constant over output, this calculation gives the same relative prices irrespective of total or average cost is being used. If average costs vary with output, prices depend upon both demand and supply.