

## 8. THEORIES OF INTERNATIONAL TRADE

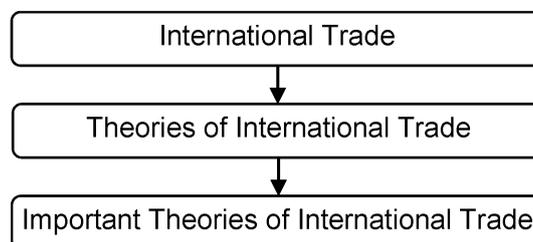
### MODEL WISE ANALYSIS OF PAST EXAM PAPERS OF IPCC AND CA INTER

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### SECTION 1: THEORY FOR CLASSROOM DISCUSSION



**Q.No.1. Define the terms internal trade and International trade. Also compare them. (A) (SM)**

- 1) DOMESTIC TRADE OR INTERNAL TRADE:** Domestic trade involves exchange of goods and services within the domestic territory of a country using domestic currency.
- 2) INTERNATIONAL TRADE:** International trade is the exchange of goods and services as well as resources between countries. It involves transactions between residents of different countries and also in multiple currencies.
- 3) SPECIFICATIONS OF INTERNATIONAL TRADE IN COMPARISON TO INTERNAL TRADE:** International trade has greater complexity as it involves:

- a) Heterogeneity of customers and currencies
- b) Differences in legal systems
- c) More elaborate documentation
- d) Diverse restrictions in the form of taxes, regulations, duties, tariffs, quotas, trade barriers, and standards
- e) Restraints to movement of specified goods and services
- f) Issues related to shipping and transportation

#### **DIFFERENCES BETWEEN INTERNAL TRADE AND INTERNATIONAL TRADE:**

Basis	Internal Trade	International trade
Meaning	Internal trade refers to buying and selling of goods within the geographical limits of a country.	International trade refers to buying and selling of goods beyond the geographical limits of a country
Countries Involved	Only one country is involved.	Minimum Two countries are involved.
Currency	Payments are made and received in home currency only.	Payment are made and received in mutually agreed foreign currency only.
Risk	Less degree of risk is involved.	High degree of risk is involved, such as transit risk, risk of fluctuation of currency and demand etc.
Procedure involved	Very less procedure and formalities required.	Long procedures and many formalities are required for conducting external trade.
Government Restrictions	Internal trade is not restricted, except on few goods.	External trade is strictly monitor by the government and prior approval is required before external transaction.
License required	License is not compulsory in internal trade.	License is compulsory in International Trade.

**NOTE:** At present, liberal international trade is an integral part of international relations and has become an important engine of growth in developed as well as developing countries.

#### **SIMILAR QUESTIONS:**

1. Define International trade
  - A. Refer 2<sup>nd</sup> point
2. Describe how international trade differs from internal trade or domestic trade
  - A. Refer 3<sup>rd</sup> point
3. Define international trade and describe how it differs from internal trade?
  - A. Refer above answer

#### **Q.No.2. Examine the arguments in support of International trade. (A) (SM) (SELF STUDY)**

Some economists and policy makers argue that there are net benefits from keeping markets open to international trade and investments in the following ways:

#### **1) AS STIMULUS TO ECONOMIC EFFICIENCY:**

- a) The wider market (trade) induces companies to reap the quantitative and qualitative benefits of extended division of labour.
- b) It enlarges their manufacturing capabilities and benefit from economies of large scale production.
- c) Efficient deployment of productive resources to their best uses is a direct economic advantage of foreign trade.
- d) Greater efficiency in the use of natural, human, industrial and financial resources ensures productivity gains.

e) It tends to decrease the likelihood of domestic monopolies and is always beneficial to the community.

**2) ENHANCES THE DOMESTIC COMPETITIVENESS:**

a) The gains from international trade are reinforced by the domestic producers to compete against global businesses.

b) Competition from foreign goods compels manufacturers to enhance efficiency and profitability by adoption of cost reducing technology and business practices.

**3) ADVANTAGE OF INTERNATIONAL TRADE TECHNOLOGY:**

a) It augments the scope for automation, mechanization and specialization.

b) It provides access to new markets and new materials and enables sourcing of inputs and components internationally at competitive prices.

c) This reflects in innovative products at lower prices and wider choice in products and services for consumers.

4) Trade Exports stimulate economic growth by creating jobs, augmenting factor incomes and in raising living standards and overall demand for goods and services (reduces poverty).

5) It provides greater stimulus to innovative services in banking, insurance, logistics, consultancy services etc.

6) Employment generating investments, including foreign direct investment, inevitably follow trade.

7) For emerging economies, improvement in the quality of output of goods and services, superior products, finer labour and environmental standards etc enhance the value of their products and enable them to move up the global value chain.

8) It enhances productive base and facilitates export diversification so that new production possibilities are opened up.

9) Countries can gainfully dispose off their surplus output and, thus, prevent undue fall in domestic prices caused by overproduction.

10) It also allows nations to maintain stability in prices and supply of goods during periods of natural calamities like famine, flood, epidemic etc.

11) It contributes to Human Resource Development (HRD) by facilitating fundamental and applied research and exchange of know-how and best practices between trade partners.

12) It strengthens bonds between nations by bringing citizens of different countries together in mutually beneficial exchanges and, thus, promotes harmony and cooperation among nations.

13) It enables nations to acquire foreign exchange reserves necessary for imports which are crucial for sustaining their economies.

**SIMILAR QUESTIONS:**

1. How does the international trade increase economic efficiency? Explain.

(M19 – 3M, MTP - M20)

A. Refer 1<sup>st</sup> point

2. Elucidate the arguments in favour of liberal trade.

A. Support your answer according to weightage of the question

**Q.No.3. Examine the arguments against to International trade.**

**(A) (SM) (SELF STUDY)**

Often the liberal global trade and investments are criticized as detrimental to national interests. The major arguments put forth against trade openness are:

**1) POSSIBLE NEGATIVE LABOUR MARKET OUTCOMES IN TERMS OF:**

a) Labour-saving technological change that depress demand for unskilled workers.

b) Loss of labourers bargaining power.

- c) Downward pressure on wages of semi-skilled and unskilled workers.
- d) Forced work under unfair circumstances and unhealthy occupational environments.
- 2) **INTERNATIONAL TRADE IS OFTEN NOT EQUALLY BENEFICIAL TO ALL NATIONS:**
- a) Potential unequal market access and disregard for the principles of fair trading system may increase the differences between trading countries (if they differ in their wealth).
- b) Economic exploitation occurs when underprivileged countries become vulnerable to the growing political power of corporations operating globally.
- 3) **NEGATIVE IMPACT ON NATURAL RESOURCES:**
- a) It keeps excessive stress on exports and profit-driven exhaustion of natural resources due to unsustainable production and consumption.
- b) Substantial environmental damage and exhaustion of natural resources in a shorter span of time could have serious negative consequences on the society at large.
- 4) Probable shift towards a consumer culture and change in patterns of demand in favour of foreign goods which are likely to occur in less developed countries may have adverse effect on the development of domestic industries and may even threaten the survival of infant industries.
- 5) Trade cycles associated with economic crises occurring in different countries get transmitted rapidly to other countries.
- 6) **RISKY DEPENDENCE OF UNDERDEVELOPED COUNTRIES ON FOREIGN NATIONS:**
- a) It impairs economic autonomy and endangers their political sovereignty.
- b) It leads to widespread exploitation and loss of cultural identity.
- c) Substantial dependence may have severe adverse consequences in times of wars and other political disturbances.
- 7) **WELFARE OF PEOPLE MAY BE IGNORED OR JEOPARDIZED FOR THE SAKE OF PROFIT:**
- a) Excessive exports may cause shortages of many commodities in the exporting countries and lead to high inflation (e.g. onion price rise in 2014).
- b) Import of harmful products may cause health hazards and environmental damage. (E.g. Chinese products).
- 8) Too much export orientation may distort actual investments away from the genuine investment needs of a country.
- 9) Instead of cooperation among nations, trade may breed rivalry on account of severe competition.
- 10) There is often lack of transparency and predictability in many aspects related to trade policies of trading partners.
- 11) There are also many risks in trade which are associated with imposition of an import ban or trade embargoes etc.

**SIMILAR QUESTIONS:**

1. Elucidate the arguments in against liberal trade.
  - A. Refer above answer
2. Do you think international trade is always beneficial? Substantiate your arguments?
  - A. Refer above answer
3. What are the major arguments against liberal trade?
  - A. Support your answer according to weightage of the question

**Q.No.4. Explain the Mercantilists' View of International Trade.**

**(B) (SM)**

**MERCANTILISM:** It was the policy of Europe's great powers, based on the premise that national wealth and power are best served by increasing exports and collecting precious metals in return.

**MERCANTILISTS' VIEW OF INTERNATIONAL TRADE:**

- 1) Mercantilists believed that the more gold and silver a country accumulates, the richer it becomes.
- 2) Mercantilism advocated maximizing exports in order to bring in more "specie" (precious metals) and minimizing imports through imposing very high tariffs on foreign goods by the state.
- 3) This view argues that trade is a 'zero-sum game', with winners who win does so only at the expense of losers, and one country's gain is equal to another country's loss, so that the net change in wealth or benefits among the participants is zero.

The arguments put forth by mercantilists were later proved to have many shortcomings by later economists. But it is still very important theory which explains policies followed by many big and fast growing economies in Asia.

**ADDITIONAL INFORMATION:** Mercantilism is also refer as 'Commercialism' and it was the popular economic philosophy in 17<sup>th</sup> and 18<sup>th</sup> Centuries

**SIMILAR QUESTIONS:**

1. Explain the mercantilists' views on international trade. Illustrate how trade can be based on absolute advantage.
  - A. Refer above answer
2. What is the major idea behind Mercantilist's view of trade?
  - A. Refer above answer

**Q.No.5. Explain the "Theory of Absolute Advantage" with reference to international trade (A) (SM)**

**INTRODUCTION:** Adam Smith was the first to put across the possibility that international trade is not a zero-sum game.

According to Adam Smith who supported unrestricted trade and free international competition, absolute cost advantage is the determinant of mutually beneficial international trade.

**THEORY OF ABSOLUTE COST ADVANTAGE:** The absolute cost advantage theory points out that a country will specialize in the production and export of a commodity in which it has an absolute cost advantage. (i.e. exchange of goods between two countries will take place only if each of the two countries can produce one commodity at an absolutely lower production cost than the other country).

**BASIS OF THE THEORY OF INTERNATIONAL TRADE IN THE WORDS OF SMITH:** "Principle of division of labour".

**ASSUMPTIONS OF THE THEORY:**

- 1) Absolute advantage exists between nations when they differ in their ability (labour) to produce goods.
- 2) Each nation can produce one good with less expenditure of human labour or more cheaply than the other.
- 3) Each nation has an absolute advantage in the production of one good only.

**NUMERICAL EXAMPLE GIVEN BY ADAM SMITH:** The theory is presented with an example of a hypothetical two countries and two commodities model (2x2 model).

**OUTPUT PER HOUR OF LABOUR:**

Commodity	Country A	Country B
Wheat (bushels/hour)	6	1
Cloth (yards/hour)	4	5

**FROM THE ABOVE TABLE:**

- 1) One hour of labour time produces 6 bushels and 1 bushel of wheat respectively in country A and country B. Country A is more efficient than country B, or Country A has an absolute advantage over country B in production of wheat.
- 2) One hour of labour time produces 4 yards of cloth in country A and 5 in country B. Country B is more efficient than country A, or Country B has an absolute advantage over country A in the production of cloth.

- 3) If both nations can engage in trade with each other, each nation will specialize in the production of the good it has an absolute advantage in and obtain the other commodity through international trade. Therefore, country A would specialise completely in production of wheat and country B in cloth.

#### **EXPLANATION TO THE MUTUAL GAINFUL TRADE:**

- 1) If country A exchanges six bushels of wheat (6W) for six yards of country B's cloth (6C), then country A gains 2C or saves 30 minutes of labour time (since the country A can only exchange 6W for 4C domestically).
- 2) The 6W that country B receives from country A is equivalent to or would require six hours of labour time to produce in country B. These same six hours can produce 30C in country B (6 hours x 5 yards of cloth per hour). By being able to exchange 6C (requiring a little over one hour to produce in the country B) for 6W, country B gains 24C, or saves nearly five hours of work.

#### **INFERENCE:**

- 1) Mutual gainful trade is possible only when one country has absolute advantage and the other has absolute disadvantage in the production of at least one commodity.
- 2) Though trade is advantageous, gains may not be distributed equally, because their given resources are utilized more efficiently, therefore, both countries can produce larger quantities of commodities which they specialize in.
- 3) By specialising and trading freely, global output is, thus, maximized and more of both goods are available to the consumers in both the countries.
- 4) If they specialise but do not trade freely, country A's consumers would have no cloth, and country B's consumers would have no wheat. That is not desirable situation.

#### **SIMILAR QUESTION:**

1. What is meant by absolute advantage in terms of international trade?  
A. Refer 2<sup>nd</sup> side heading

**Q.No.6. Explain the "Theory of Comparative Advantage" as stated by David Ricardo with reference to international trade. (A) (SM) (M19 – 3M)**

David Ricardo developed the classical theory of comparative advantage in his book 'Principles of Political Economy and Taxation' published in 1817.

- 1) **LAW OF COMPARATIVE ADVANTAGE:** If one nation has absolute advantage in the production of both commodities and another nation has absolute disadvantage in the production of both commodities, then also there is still scope for mutually beneficial trade. This is explained by Ricardo with the concept of 'comparative advantage'
  - a) It states that even if one nation is less efficient (has an absolute disadvantage) than other nation in the production of all commodities, there is still scope for mutually beneficial trade.
  - b) The nation which has absolute disadvantage in both commodities should specialize in the production and export of the commodity in which its absolute disadvantage is smaller (i.e. its comparative advantage) and import the commodity in which its absolute disadvantage is greater (i.e. its comparative disadvantage). Or A country should produce and export of a commodity in which its comparative advantage is greater and import a commodity in which its comparative disadvantage is less.
- 2) **ANALYSIS BY RICARDO:** Labour differs in its productivity internationally and different goods have different labour requirements. So the comparative labour productivity advantage was Ricardo's predictor of trade.

#### **EXAMPLE:**

#### **OUTPUT PER HOUR OF LABOUR:**

Commodity	Country A	Country B
Wheat (bushels/hour)	6	1
Cloth (yards/hour)	4	2

**FROM THE ABOVE TABLE:**

- 1) In a two-nation, two-commodity world, once trade is established that one nation has a comparative advantage in one commodity, then the other nation must necessarily have a comparative advantage in the other commodity.
- 2) Country B has absolute disadvantage in the production of both wheat and cloth. B's labour is only half as productive in cloth but six times less productive in wheat compared to country A. The country B's absolute disadvantage is smaller in cloth, so B's comparative advantage lies in cloth production.
- 3) Country A has an absolute advantage in both wheat and cloth with respect to the country B. But its absolute advantage is greater in wheat (6:1) than in cloth (4:2), and so country A has a comparative advantage in production and exporting wheat.

**BOTH NATIONS CAN GAIN FROM TRADE EVEN IF COUNTRY B IS LESS EFFICIENT THAN COUNTRY A IN THE PRODUCTION OF BOTH COMMODITIES:**

- 1) Both nations can gain if country A specialises in the production of wheat and exports some of it in exchange for country B's cloth.
- 2) Simultaneously, country B should specialize in the production of cloth and export some of it in exchange for country A's wheat.

**EXPLANATION TO THE LAW:**

- 1) Assume that country A could exchange 6W for 6C with country B. Then, country A would gain 2C (or save half an hour of labour time) since the country A could only exchange 6W for 4C domestically.
- 2) Country B which receives 6W from country A would require six hours of labour time to produce in country B. With trade, country B can instead use these six hours to produce 12C and give up only 6C for 6W from country A. Thus, the country B would gain 6C or save three hours of labour time.

**THE GAINS OF BOTH COUNTRIES ARE NOT LIKELY TO BE EQUAL:**

- 1) The mutual beneficial trade can take place not only with the rate of exchange but also other factors may influence.
- 2) For country A the more C it gets, the greater would be the gain from trade.
- 3) In country B, 6W = 12C (both require 6 hours to produce). Anything less than 12C that country B must give up to obtain 6W from country A represents a gain from trade for country B.
- 4) The range for mutually advantageous trade is  $4C < 6W < 12C$ .
- 5) The spread between 12C and 4C (i.e., 8C) represents the total gains from trade available to be shared by the two nations by trading 6W for 6C.
- 6) The closer the rate of exchange is to  $4C = 6W$  (domestic rate in country A), the smaller is the gain to country A, and the larger will be the gain to country B.
- 7) Alternatively, the closer the rate of exchange is to  $6W = 12C$  (domestic rate in country B), the greater is the gain of country A relative to that of country B.
- 8) However, if the absolute disadvantage of one nation with respect to another nation is the same in both commodities, there will be no comparative advantage and no trade.

**CONCLUSION:** Ricardo based his law of comparative advantage on the 'labour theory of value', which assumes that the value or price of a commodity depends exclusively on the amount of labour going into its production. This is quite unrealistic because labour is not the only factor of production, nor it is used in the same fixed proportion in the production of all commodities.

**SIMILAR QUESTIONS:**

1. Describe the Ricardian theory of comparative advantage in terms of international trade?
  - A. Refer above answer
2. Using Ricardian model, explain how two countries can gain from trade? What does the Ricardian model suggest regarding the effect of trade?
  - A. Refer above answer
3. Explain the classical theory of Comparative Advantage as given by David Ricardo. (M19-3M)
  - A. Refer above answer

4. What is the basis for international trade according to Ricardo?  
 A. Refer 1<sup>st</sup> and 2<sup>nd</sup> points
5. Even if one nation is less efficient than the other nation in the production of all commodities, there is still scope for mutually beneficial trade. Explain in detail. (RTP – M20)  
 A. Refer above answer

**Q.No.7. Explain how Haberler resolved Ricardo's unrealistic assumption of law of comparative advantage based on the 'labour theory of value'? (B) (SM)**

**ISSUE:** Ricardo's law of comparative advantage was based on the 'labour theory of value', which assumes that the value or price of a commodity depends exclusively on the amount of labour going into its production. This is quite unrealistic because labour is not the only factor of production, nor is it used in the same fixed proportion in the production of all commodities.

**RESOLVED BY:** Haberler in 1936

**CONCEPT USED BY HABERLER:** Opportunity cost (It is a part of microeconomic theory to explain the theory of comparative advantage in which no assumption is made in respect of labour as the source of value.

**OPPORTUNITY COST:**

- 1) It is the value of the forgone option.
- 2) It is the 'real' cost in microeconomic terms, as opposed to cost given in monetary units.
- 3) According to the opportunity cost theory, the cost of a commodity is the amount of a second commodity that must be given up to release just enough resources to produce one extra unit of the first commodity. Or O.C. of a commodity is, quantity of a second commodity that must be given up to produce one extra unit of first commodity.
- 4) The opportunity cost of producing one unit of good X in terms of good Y may be computed as how much Y do have to give up in order to produce one more unit of good X.
- 5) Logically, the nation with a lower opportunity cost in the production of a commodity has a comparative advantage in that commodity and a comparative disadvantage in the second commodity.

**EXAMPLE:**

**OUTPUT PER HOUR OF LABOUR:**

Commodity	Country A	Country B
Wheat (bushels/hour)	6	1
Cloth (yards/hour)	4	2

**FROM THE GIVEN TABLE:**

- 1) We find that country A must give up two-thirds of a unit of cloth to release just enough resources to produce one additional unit of wheat domestically. Therefore, the opportunity cost of one wheat is two-thirds of a unit of cloth (i.e., Opportunity Cost of 1W = 2/3C in country A).
- 2) Similarly, in country B, it is 1W = 2C, and the opportunity cost of wheat is lower in country A than in country B, and country A would have a comparative (cost) advantage over country B in wheat.
- 3) In a two-nation, two-commodity world, if country A has a comparative advantage in wheat, then country B will have a comparative advantage in cloth.
- 4) Therefore, country A should consider specializing in producing wheat and export some of it in exchange for cloth produced in country B.
- 5) By such specialization and trade, both nations will be able to consume more of both commodities than what would have been possible without trade.

**CENTRAL THEME OF THE CONCEPT:**

- 1) International differences in relative factor-productivity are the cause of comparative advantage and a country exports goods that it produces relatively efficiently.

- 2) It leads to tendency towards complete specialization in production.
- 3) Ricardo demonstrated that for two nations without input factor mobility, specialization and trade could result in increased total output and lower costs than if each nation tried to produce in isolation.
- 4) Trade generates welfare gains and both countries can potentially gain from trade.
- 5) Therefore, international trade need not be a zero-sum game.

#### **LIMITATIONS:**

- 1) Its emphasis is on supply conditions and excludes demand patterns.
- 2) The theory does not examine why countries have different costs.
- 3) The theory does not answer the important question "Why does a nation have comparative advantage in the production of a commodity and comparative disadvantage in the production of another?"

#### **SIMILAR QUESTION:**

1. What is meant by opportunity cost?
- A. Refer Opportunity cost side heading

#### **Q.No.8. Outline the Heckscher-Ohlin Theory of Trade**

**(A) (SM)**

- 1) **THEORY OF INTERNATIONAL TRADE:** The Heckscher-Ohlin theory of trade
- 2) **ENTITLED:** Named after two Swedish economists, Eli Heckscher and his student Bertil Ohlin
- 3) **OTHER NAMES OF HECKSCHER-OHLIN THEORY OF TRADE:**
  - a) Factor-Endowment Theory of Trade
  - b) Modern Theory of Trade
  - c) Heckscher-Ohlin-Samuelson theorem (As contributions also made by P. A. Samuelson)
- 4) **ASSUMPTIONS OF HECKSCHER-OHLIN THEORY OF TRADE:**
  - a) International trade is a special case of inter-regional trade.
  - b) **Different Countries have different factor endowments(labour and capital):**  
Some regions have abundance of labour, but scarcity of capital; whereas other regions have abundance of capital, but scarcity of labour.
  - c) Two countries share the same production technology and markets are perfectly competitive.
  - d) **Different goods have different production functions:**
    - i) Factors of production are combined in different proportions to produce different commodities.
    - ii) While some goods are produced by employing a relatively larger proportion of labour and relatively small proportion of capital, other goods are produced by employing a relatively small proportion of labour and relatively large proportion of capital.
- 5) **SALIENT FEATURES OF THE THEORY:** The theory states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments of the nations. ('Factor endowment' refers to the overall availability of usable resources including both natural and man-made means of production)
  - a) Before international trade, two countries have different factor endowments under identical production function and identical preferences. Hence different factor prices and different cost functions in the beginning.
  - b) The theory states that a country's exports depend on its resources endowment i.e. whether the country is capital-abundant or labour-abundant.
  - c) If a country is a capital abundant one, it will produce and export capital-intensive goods relatively more cheaply than another country.
  - d) A labour-abundant country will produce and export labour-intensive goods relatively more cheaply than another country.

- e) The labour-abundant countries have comparative cost advantage in the production of goods which require labour-intensive technology and capital-abundant countries have comparative cost advantage in the production of goods that need capital-intensive technology.
  - f) Whichever factor receives the lowest price before two countries integrate economically and effectively become one market will therefore tend to become more expensive relative to other factors in the economy, while those with the highest price will tend to become cheaper
  - g) The theory postulates that foreign trade eliminates the factor price differentials.
- 6) The Heckscher-Ohlin theory of foreign trade can be stated in the form of two theorems namely, Heckscher-Ohlin Trade Theorem and Factor-Price Equalization Theorem.

**Q.No.9. The Heckscher-Ohlin theory of foreign trade can be stated in the form of two theorems. What are they and explain them briefly? (A) (SM)**

The Heckscher-Ohlin theory of foreign trade can be stated in the form of two theorems namely, Heckscher-Ohlin Trade Theorem and Factor-Price Equalization Theorem.

**THE HECKSCHER-OHLIN TRADE THEOREM:** It establishes that a country tends to specialize in the export of a commodity whose production requires intensive use of its abundant resources and imports a commodity whose production requires intensive use of its scarce resources.

**EXPLANATION OF THE THEORY WITH AN EXAMPLE OF TRADE OF CLOTH BETWEEN TWO COUNTRIES:**

**Country A:** Labour-abundant country

**Country B:** Capital-abundant country

- 1) The opening up to trade for a Country A (labour-abundant country) will increase the price of labour-intensive goods, say clothes, and, thus, lead to an expansion of clothes production.
- 2) As there is demand for exports of clothes in foreign markets, the demand for factors of production increases in the clothes sector.
- 3) Because clothes are labour-intensive goods, an increasing demand for labour in the factor market will attract labour from the capital-intensive industry, say machine tools.
- 4) The expanding clothes industry absorbs relatively more labour than the amount released by the contracting machine tools industry.
- 5) The price of labour goes up, and its relative price increases, the relative price of capital declines.
- 6) As a result, the factors of production will become more capital-intensive in both sectors leading to a decline in the marginal productivity of capital and an increase in that of labour in both sectors.
- 7) When country B increases its specialization in the production of capital-intensive commodity its demand for capital increases causing capital returns to increase in relation to wage rate. This means that specialization leads to change in relative factor prices.
- 8) When the prices of the output of goods are equalized between countries as they move to free trade, then the prices of the factors (capital and labour) will also be equalized between countries.
- 9) It means that product mobility and factor mobility become perfect substitutes.
- 10) Whichever factor receives the lowest price before two countries integrate economically and effectively become one market will therefore tend to become more expensive relative to other factors in the economy, while those with the highest price will tend to become cheaper.

**THE FACTOR-PRICE EQUALIZATION THEOREM:**

- 1) It states that international trade tends to equalize the factor prices between the trading nations.
- 2) In the absence of foreign trade, it is quite likely that factor prices are different in different countries.
- 3) International trade equalizes the absolute and relative returns to homogenous factors of production and their prices (i.e. the wages of homogeneous labour and returns to homogeneous capital will be the same in all those nations which engage in trading).

- 4) The factor price equalization theorem says that if the prices of the output of goods are equalised between countries engaged in free trade, then the price of the input factors will also be equalised between countries.
- 5) This implies that the wages and rents will converge across the countries with free trade, or in other words, trade in goods is a perfect substitute for trade in factors.

**CONCLUSION:** The Heckscher-Ohlin theorem postulates that foreign trade eliminates the factor price differentials. The factor price equalization theorem is in fact a corollary to the Heckscher-Ohlin trade theory. It holds only so long as Heckscher-Ohlin Theorem holds.

**Q.No.10. Narrate New Trade Theory. What are its arguments?**

**(A) (SM)**

**NEW TRADE THEORY (NTT):** NTT is an economic theory that was developed in the 1970's as a way to understand international trade patterns.

NTT came about to help us understand why developed and big countries are trade partners when they are trading similar goods and services. (These countries constitute more than 50% of world trade). This is particularly true in key economic sectors such as electronics, IT, food, and automotive.

*E.g.1. we have cars made in the India, yet we purchase many cars made in other countries.*

*E.g.2. India produces mobile phones and also imports them.*

**ACCORDING TO NTT, TWO KEY CONCEPTS GIVE ADVANTAGES TO COUNTRIES THAT IMPORT GOODS TO COMPETE WITH PRODUCTS FROM THE HOME COUNTRY:**

- 1) **Economies of Scale:** As a firm produces more of a product its cost per unit keeps going down. So if the firm serves domestic as well as foreign market instead of just one, it can reap the benefit of large scale of production consequently the profits are likely to be higher.
- 2) **Network effects:**
  - a) Network effects are the way one person's value of a good or service is affected by the value of that good or service to others.
  - b) The value of the product or service is enhanced as the number of individuals using it increases. This is also referred to as the 'bandwagon effect'.
  - c) Consumers like more choices, but they also want products and services with high utility, and the network effect offers increased utility from these products over others.

*E.g. Mobile App such as Whats App and software like Microsoft Windows.*

**Arguments of New Trade Theory:**

- a) NTT argues that, because of substantial economies of scale and network effects, it pays to export phones to sell in another country.
- b) Those countries with the advantages will dominate the market, and the market takes the form of monopolistic competition (*the firms producing a similar product that isn't exactly the same, but awfully close*).

**SIMILAR QUESTION:**

1. What are two key concepts of New Trade Theory that give advantages to countries that import goods to compete with products from the home country?
  - A. Refer 2<sup>nd</sup> side heading
2. Explain the concept of Network effect in terms of New trade theory
  - A. Refer point 2 in 2<sup>nd</sup> side heading
3. Define the term Bandwagon effect.
  - A. Refer point 2(b) in 2<sup>nd</sup> side heading

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## SECTION 2: QUESTIONS FOR ACADEMIC INTEREST FOR STUDENT SELF STUDY

**Q.No.11. What are the merits and demerits of Theory of Absolute advantage?**

**(B)**

**1) MERITS OF THEORY OF ABSOLUTE ADVANTAGE:**

- a) Gains may not be distributed equally, because their given resources are utilized more efficiently, and, therefore, both countries can produce larger quantities of commodities which they specialize in.
- b) By specializing and trading freely, global output is, thus, maximized and more of both goods are available to the consumers in both the countries.
- c) If they specialize but do not trade freely, country A's consumers would have no wheat, and country B's consumers would have no rice. That is not desirable situation.

**2) DEMERITS OF THEORY OF ABSOLUTE ADVANTAGE:**

- a) It is too simple model to consider. It does not recognize many practical barriers to International trade.
- b) Labour is considered as the only factor input in the analysis of Absolute advantage.
- c) It does not consider situations where one country has absolute advantage over another country in two commodities, and the second country has absolute disadvantages over first country in both commodities.
- d) It emphasizes only supply-side conditions, and ignores domestic demand in respective countries.

**Q.No.12. "International trade is a special case of inter-regional trade" Comment.**

**(C) (SM)**

**INTERNATIONAL TRADE IS A SPECIAL CASE OF INTER-REGIONAL TRADE:**

- 1) Each region is suitable for the production of those goods for whose production it has relatively plentiful supply of the requisite factors.
- 2) A region is not suitable for production of those goods for whose production it has relatively scarce or zero supply of essential factors.
- 3) Hence different regions have different capacity to produce different commodities.
- 4) Therefore, difference in factor endowments is the main cause of international trade as well as inter-regional trade.
- 5) The immediate cause of inter-regional trade is that goods can be bought cheaper in terms of money than they can be produced at home and this is the case of international trade as well.
- 6) The cause of difference in the relative prices of goods is the difference the amount of factor endowments, like capital and labour, between two countries.

## SECTION 3: DIFFERENCES FOR STUDENTS SELF STUDY

**Q.No.13. Compare the theory of comparative costs and modern theory.**

**(A)**

THEORY OF COMPARATIVE COSTS	MODERN THEORY
The basis is the difference between countries is comparative costs.	Explains the causes of difference in comparative costs as differences in factor endowments.
Based on labour theory of value.	Based on money cost which is more realistic.
Considered labour as the sole factor of production and presents a one-factor (labour) model.	Widened the scope to include labour and capital as important factors of production. This is two-factor model and can't be extended to more factors.

Treats international trade as quite distinct from domestic trade.	International trade is only a special case of inter-regional trade.
Studies only comparative costs of the goods concerned.	Considers the relative prices of the factors which influence the comparative costs of the goods.
Attributes the differences in comparative advantage to differences in productive efficiency of workers.	Attributes the differences in comparative advantage to the differences in factor endowments.
Does not take into account the factor price differences.	Considers factor price differences as the main cause of commodity price differences.
Does not provide the cause of differences in comparative advantage.	Explains the differences in comparative advantage in terms of differences in factor endowments.
Normative; tries to demonstrate the gains from international trade.	Positive; concentrates on the basis of trade.

**SIMILAR QUESTION:**

- Describe the reasons for the superiority of Hecksher Ohlin theory of international trade over the classical theory of international trade.  
A. Refer above answer

**SECTION 4: TEST YOUR KNOWLEDGE**

- What happens if a country had higher productivity in both commodities compared to another country?
- What is the major idea behind Mercantilist's view of trade?
- How does trade increase economic efficiency and which view argued that trade is a zero-sum game and how? (MTP-N19)
- Mention the core principle of the theory of comparative advantage. (RTP M19)
- What is meant by 'factor endowment' in the theory of international trade?
- What is the crux of Heckscher-Ohlin theory of international trade?
- What do you understand by 'factor-price equalization' in the context of international trade?
- What is meant by "Principle of division of labour"?
- What is meant by 'bandwagon effect'?
- Describe the reasons why international trade is opposed by many people?
- "Specialization in production always increases the prosperity of a country" Do you agree with the statement? Substantiate your answer.
- Do you think the developing countries will be disproportionately disadvantaged if they engage in liberal trade?
- What consequences do you foresee for the industrial sector if a nation has greater openness of trade?
- Explain the key features of modern theory of international trade. [N19 - 2M]

**SECTION 5: LIST OF FORMULAE**

1) Terms of Trade =  $\frac{\text{Index of Export Prices}}{\text{Index of Import Prices}} \times 100 = \frac{P_x}{P_m} \times 100$

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## SECTION 6: PROBLEMS FOR CLASSROOM DISCUSSION

- 1) The price index for exports of Country A in year 2012 (2000 base-year), was 116.1 and the price index for Country A's imports was 120.2 (2000 base-year)
- What do these figures mean? (ANS.: REFER QUESTION)
  - How do you interpret the price index for Country A's imports in comparison with 2000 as its base-year? (ANS.: 120.2)
  - How do you interpret the index of terms of trade for Country A? (ANS.: TERMS OF TRADE: 96.6)
- (SOLVE PROBLEM NO. 1 OF ASSIGNMENT PROBLEMS AS REWORK)

- 2) The table below shows the number of labour hours required to produce wheat and cloth in two countries X and Y. (MTP1 M19 - 3M) (MTP1 M18 - 3M)

Commodity	Country X	Country Y
1 unit of cloth	4	1.0
1 unit of wheat	2	2.5

- Compare the productivity of labour in both countries in respect of both commodities. (ANS.: COUNTRY X: CLOTH: 0.25 PER HOUR, WHEAT: 0.5 PER HOUR; COUNTRY Y: CLOTH: 1 PER HOUR, WHEAT: 0.4 PER HOUR)
  - Which country has absolute advantage in the production of wheat? (ANS.: COUNTRY X)
  - Which country has absolute advantage in the production of cloth? (ANS.: COUNTRY Y)
- (SOLVE PROBLEM NO. 2, & 4 OF ASSIGNMENT PROBLEMS AS REWORK)
- 3) The following Table gives you the capacity of two products in two countries.

Time required for 1 unit of	Product X	Product Y
Country A	40 hours	45 hours
Country B	60 hours	50 hours

- Compute the Production per hour for both Products in both Countries. (ANS.: COUNTRY A: 'X': 0.025, 'Y': 0.022; COUNTRY B: 'X': 0.017, 'Y': 0.020)
  - Is absolute cost advantage theory is applicable for the above situation. (ANS.: THERE WILL BE NO TRADE IN BETWEEN THESE COUNTRIES AS IF ABSOLUTE COST ADVANTAGE THEORY APPLIED)
  - Which country has comparative advantage in the production of product X? (ANS.: COUNTRY A)
  - Which country has comparative advantage in the production of product Y? (ANS.: COUNTRY B)
- (SOLVE PROBLEM NO. 3 OF ASSIGNMENT PROBLEMS AS REWORK)
- 4) Countries China and India have a total of 6000 hours each of labour available each day to produce shirts and trousers. Both countries use equal number of hours on each good each day. China produces 1000 shirts and 300 trousers per day. India produces 300 shirts and 200 trousers per day. In the absence of trade:
- Which country has absolute advantage in producing Shirts and Trousers?
  - Which country has comparative advantage in producing Shirts and Trousers?
- (MTP N20) (ANS.: CHINA HAS LOWER OPPORTUNITY COST FOR PRODUCING SHIRTS, THEREFORE CHINA HAS COMPARATIVE ADVANTAGE; INDIA HAS LOWER OPPORTUNITY COST FOR PRODUCING TROUSERS, THEREFORE INDIA HAS COMPARATIVE ADVANTAGE)
- 5) Countries Rose Land and Daisy land have a total of 4000 hours each of labour available each day to produce shirts and trousers. Both countries use equal number of hours on each good each day. Rose Land produces 800 shirts and 500 trousers per day. Daisy land produces 500 shirts and 250 trousers per day. In the absence of trade:
- Which country has absolute advantage in producing shirts or trousers?

- b) Which country has comparative advantage in producing shirts or trousers?

(RTP N20) (ANS.: DAISY LAND HAS LOWER OPPORTUNITY COST FOR PRODUCING SHIRTS, THEREFORE DAISY LAND HAS COMPARATIVE ADVANTAGE; ROSE LAND HAS LOWER OPPORTUNITY COST FOR PRODUCING TROUSERS, THEREFORE ROSE LAND HAS COMPARATIVE ADVANTAGE)

### SECTION 7: ASSIGNMENT PROBLEMS

- 1) In 2012, the island of Madagascar had an index of export prices of 15% (115) over the previous year and an index of import prices of 7% (107) over the previous year. Calculate Terms of trade of Madagascar economy. (ANS.: 107.5)

- 2) The table given below shows the number of labour hours required to produce Sugar and Rice in two countries X and Y: (N18 – 3M)

Commodity	Country X	Country Y
1 unit of Sugar	2.0	5.0
1 unit of Rice	4.0	2.5

- a) Compute the Productivity of labour in both countries in respect of both commodities.  
 b) Which country has absolute advantage in production of Sugar?  
 c) Which country has absolute advantage in production of Rice? (N18 - 3M)
- 3) The following Table gives you the capacity of two products in two countries. Answer the questions given below.

Product requires per unit	Product A	Product B
Country P	8 hours	9 hours
Country Q	12 hours	3 hours

- a) Compute the Production per hour for both Products in both Countries.  
(ANS.: COUNTRY P: 'A': 0.125, 'B': 0.11 UNITS; COUNTRY Q: 'A': 0.083, 'B': 0.33)
- b) Is the theory of Absolute Advantage applicable in the above case? (ANS.: YES, APPLICABLE)
- c) If your answer to Part 2 is in the affirmative, which Country has Absolute Advantage for -  
 i) Product A (ANS.: COUNTRY P)  
 ii) Product B (ANS.: COUNTRY Q)
- d) If trade takes place between these Countries, which Product should each Country produce?  
(ANS.: COUNTRY 'P' WILL PRODUCE A AND COUNTRY 'Q' WILL PRODUCE B)
- e) What is the Opportunity Cost of each Product?  
(ANS.: COUNTRY P: 0.125 UNITS OF 'A' FOR 0.11 UNITS OF 'B', COUNTRY Q: 0.083 UNITS OF 'A' FOR 0.33 UNITS FOR 'B')
- 4) The table below shows the output of Wheat and Rice by using one hour of labour time in country A and country B –

Commodity	Country A	Country B
Wheat (quintals/hour)	10	5
Rice (quintals/hour)	5	10

Which country has an absolute advantage over other country in production of wheat and rice and which good they obtain through international trade?

(RTP N 19) (ANS: SPECIALISATION: COUNTRY A IN WHEAT AND COUNTRY B IN CLOTH)

**THE END**

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