8. THEORIES OF INTERNATIONAL TRADE

ASSIGNMENT SOLUTIONS

PROBLEM NO: 1

Given, of the island of Madagascar in 2012

Index of Export Prices over the previous year = 15%;

Index of Export Prices (P_X) = 115

Index of Import Prices over the previous year = 7%

Index of Import Prices (P_m) = 107

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

$$= \frac{115}{107} \times 100 = 107.47 \cong 107.5$$

PROBLEM NO: 2

a) Productivity of Labour (per hour):

Commodity	Country X	Country Y
Sugar	½ = 0.5 units per hour	1/5 = 0.2 units per hour
Rice	¼ = 0.25 units per hour	1/2.5 = 0.4 units per hour

b) Country X has absolute advantage in production of Sugar (0.5 units per hour > 0.2 units per hour) over Country Y

c) Country Y has absolute advantage in production of Sugar (0.4 units per hour > 0.25 units per hour) over Country X

PROBLEM NO: 3

a) The table given in the question can be written in the form of Production per Hour, as under:

	Product A	Product B
Country P	1/8 = 0.125 units per hour	1/9 = 0.11 units per hour
Country Q	1/12 = 0.083 units per hour	1/3 = 0.33 units per hour

b) Since 0.125 > 0.083, and 0.11 < 0.33, each Country has absolute advantage over another Country in one commodity each, the Theory of Absolute Advantage is applicable in this case.

c) Country P has Absolute Advantage in "A", 0.125 > 0.083, and Country Q has Absolute Advantage in "B" 0.33 > 0.11.

d) If International Trade takes place, Country P will produce "A", and Country Q will produce "B".

e) Opportunity Cost of each product is under -

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'.

ANSWERS FOR TEST YOUR KNOWLEDGE QUESTIONS

QUESTION NO. 1

Let us consider two countries ‘A’ and ‘B’ participating international trade where country ‘A’ has absolute advantage in the production of both commodities and country B has absolute disadvantage in the production of both commodities.

According to the concept of ‘comparative advantage’ given by Ricardo even if one country is technologically superior in both goods, it could still be advantageous for them to trade.

- Country A exports in which it has more absolute advantage to Country B and imports in which it has less absolute advantage from Country B
- Country B exports in which it has less absolute disadvantage to Country A and imports in which it has more absolute disadvantage from Country A.

QUESTION NO. 2

The major idea behind Mercantilist’s view of trade is that to encourage exports and prevent imports and accumulate as much precious metals as possible to become wealthy

QUESTION NO. 3

The Core Principle of the Theory of Comparative Advantage:

A nation should specialize in the production and export of the commodity in which its absolute disadvantage is smaller (this is the commodity of its comparative advantage) and import the commodity in which it’s absolute disadvantage is greater (this is the commodity of its comparative disadvantage).

QUESTION NO. 4

In a general sense of the term, ‘factor endowment’ which explains comparative advantage in cost of production, refers to the overall availability of usable resources including both natural and man-made means of production. Differences between countries are explained exclusively by the differences in factor endowments of the nations.

QUESTION NO. 5

Crux (Basis) of Heckscher-Ohlin theory of international trade:

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.

QUESTION NO. 6

Factor-price equalization’ in the context of international trade:

International trade equalizes the factor prices between trading nations; implies that the wages and rents will converge across the countries with free trade, 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.

QUESTION NO. 7

a) Division of work means to divide or break up a single complicated job into different smaller specialized tasks.

b) Here each of these smaller tasks is handled separately probably by an expert or a team working under his command.

c) In case, these tasks are dependent on each other’s completion, they are achieved separately and procedurally one after another.

QUESTION NO. 8

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'**.

QUESTION NO. 9

Reasons for opposing International trade by domestic people:

- Possible negative labour market outcomes.
- International trade is often not equally beneficial to all nations.
- Negative impact on Natural resources.
- Risky dependence of underdeveloped countries on foreign nations.
- 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.
- Trade cycles associated with economic crises occurring in different countries get transmitted rapidly to other countries.
- Welfare of people may be ignored or jeopardized for the sake of profit.

QUESTION NO. 10

No specialization in production by a country do not always increases the prosperity of a country. When a country specialises in a product and trade with other countries it even has to face some disadvantages from international trade such as:

- Possible negative labour market outcomes.
- International trade is often not equally beneficial to all nations.
- Negative impact on Natural resources.
- Risky dependence of underdeveloped countries on foreign nations.
- 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.
- Trade cycles associated with economic crises occurring in different countries get transmitted rapidly to other countries.
- Welfare of people may be ignored or jeopardized for the sake of profit.

THE END