9. International Trade

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Unit I- Theories of International Trade

* Introduction

→ International Trade is the exchange of goods and services as well as resources b/w countries

Benefits	Demerits
• Economic efficiency and contributes to economic growth and rising income.	• Often not equally beneficial to all nations.
• Greater efficiency in use of natural, human, Industrial and financial resources ensure productivity gains	• economic exploitation of under developed nations.
• Access to new markets and new materials.	• Substantial environmental damage
• Stimulates innovation	• Exhaustion of natural resources
• Improvement in quality of Goods & Services	• Trade cycles are also likely to get transmitted rapidly to other countries
• Contribute to human resource development.	• Dependence of underdeveloped countries on foreign nations.
• Strengthens bonds b/w countries.	• There is often lack of transparency.
etc.;	• Too much of export orientation etc.;

* Important Theories of International Trade

1.) The Mercantilist's view of International Trade

derived from Mercantile (Trade & Commercial affairs)

Exports > Imports → Favourable Balance of Trade

→ According to Microsoft Encarta Dictionary (2009), Mercantilism is the economic policy trending in Europe from 16th to 18th century, where the govt. used power to control industry and trade with the belief that National power is achieved and sustained by having constant large quantities of exports over import.

2.) The Theory of Absolute Advantage [Adam Smith]

→ In this theory, Adam Smith assumed :-

(a) Trade b/w two countries
(b) Two commodity only
(c) No transportation cost
(d) Labour was mobile within country but immobile b/w countries.
(e) Any trade b/w the two countries considered would take place if each of the two countries had an absolutely lower cost in the production of one of the commodities.

→ Adam Smith thought that the basis of International Trade was Absolute Cost Advantage. The principle of Absolute advantage refers to the ability of a party to produce greater quantity of a good using same amount of resources (Simple comparison of labour productivity)

3.) The Theory of Comparative Advantage [David Ricardo]

→ Ricardo observed that Trade was driven by comparative rather than absolute cost.

→ Ricardo's insight was that such a country would still benefit from trading according to comparative advantage - Exporting products in which absolute advantage was greatest and importing products in which absolute advantage was comparatively less.

4.) The Heckscher-Ohlin Theory of Trade

→ also known as Factor Endowment Theory or Modern Theory of Trade.

→ It states that comparative advantage in cost of production is exclusively by the differences in factor endowment.

→ A country tends to specialise :-

In Export - whose production requires intensive use of its abundant resources.

In Import - whose production requires intensive use of its scarce resources.

→ Capital abundant economy will produce and export capital intensive goods and labour abundant economy will produce and export labour intensive goods.

Theory of Comparative Cost	Modern Theory
• David Ricardo	• Heckscher and Ohlin
(i) Based on labour theory of value.	(i) Based on money cost which is more realistic.
(ii) Considered labour as sole factor.	(ii) Considered labour as well as capital.
(iii) Studies only comparative costs of goods concerned.	(iii) Considers relative prices of the factors [labour & capital]
(iv) Normative in nature.	(iv) Positive in nature.

5.) Globalisation and New International Trade Theory

→ American Economist & Journalist → Paul Krugman → received 2008 Nobel Prize for Economics for his work in economic geography and in identifying international trade pattern.

In late 1970s, Krugman noticed that the earlier model did not fit into the international trade data.

The Heckscher-Ohlin model predicted that Trade would be based on such factors as ratio of capital to labour,

But, Krugman noticed that most of the international trade takes place b/w countries with roughly the same ratio of capital to labour.

→ Krugman defended free trade →

"In praise of cheap labour" published in Slate in 1997

→ Cheap labour should be outsourced

→ Paul A Samuelson : The Factor Price Equalisation Theorem

International trade equalises the factor prices b/w trading nations.

→ NTT (New Trade Theory) gave two advantages to the countries that import goods to compete with domestic goods :-

(a) Economies of Scale → Scale of production (↑) , cost (↓)

(b) Network Effect / Bandwagon effect - The way one person's value for a good or service is affected by value of that good or service to others .

The value of product or service is enhanced as the no. of individuals using it increases .