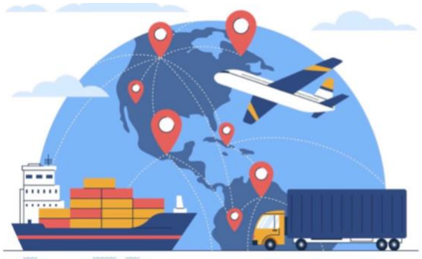
Chapter -4
Unit-1
THEORIES OF INTERNATIONAL TRADE



Transaction between residents of different countries

Benefits of International Trade

- Efficient deployment of productive resources.
- Access to New Markets & New Materials.
- Increased use of Automation, Technology & Innovation.
- Greater stimulus to services banking, logistic etc.
- Improved quality G & S, finer labour & env. Stds.
- Facilitates export diversification.
- HR Development, R & D, Exchange of Know-How etc.
- Strengthens Bond, Promote Harmony & Cooperation.

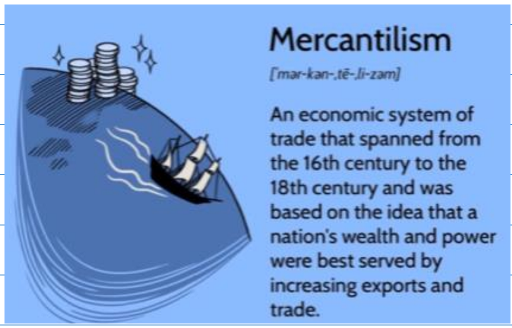
Arguments against International Trade

- Not equally beneficial to all Nations.
- Economic exploitation from growing political power.
- Environmental damage & Expansion of natural resources.
- Trade cycles & economic cries transmitted rapidly.
- Dependency impairs Autonomy & Political sovereignty.
- Too much export distort Actual investments.
- Lack of transparency & predictability to trade policy.

Important Theories of International Trade

- The Mercantilist View
- The Absolute Advantage
- The Comparative Advantage
- The New Trade Theory

The Mercantilists' View Theory



This theory belief that
National power is
Achieved & sustained by
Constant large quantities of
Exports & Imports.

Nation's Human & Resources
are
unevenly endowed,
distributed
&
developed.

This allow flow of
Labour, Material, Capital
across National boundaries
Resulting
"Mercantilism"

note to self:

CRUX

Massive & Aggressive export
over import to
Accumulate wealth & favourable BOP
is
Reason of International trade.

The Theory of Absolute Advantage

Propounded by Adam smith
↓
According to this theory basis of
International trade
is
Absolute Advantaoe.

Absolute Advantage

Ability of a party to produce greater quantity of Goods/Services than competitors using same of resources.

Product with Absolute Advantage } Export

Product with Absolute disadvantage } Import

Absolute Advantage

Country A having Absolute Advantage in Wheat.

Country B having Absolute Advantage in Clothes.

Commodity	Country A	Country B
Wheat (Bushes/Hr.)	6	1
Cloth (Yards/Hr.)	4	5

Absolute Advantage

There Fore

Country A	Country B
Export Wheat Import Clothes	Export Clothes Import Wheat

Assumptions

1. Trade between 2 countries.
2. Two country – two commodity framework.
3. 'Labour' as only Input/factor of production.
4. No transportation cost.
5. Cost were computed by relative amount of labour.
6. Labour was immobile within country but immobile between countries.
7. Trade would take place if each of the two countries had an absolutely lower cost in production of one commodity.

The Theory of Comparative Advantage

Propounded by David Ricardo
According to this theory basis of
International Trade
is
Comparative Advantage

Comparative Advantage

Even if one nation is less efficient than the other in production of all goods, still scope for mutually beneficial international trade.

Product with comparative Advantage → Export

Product with comparative disadvantage → Import

Commodity	Country A	Country B
Wheat (Bushes/Hr.)	6	1
Cloth (Yards/Hr.)	4	5

Country A having comparative Advantage

Country B having comparative disadvantage

Country A having comparative disadvantage

Country B having comparative advantage

Country A's Absolute Advantage > Country B's Absolute Advantage

There Fore

Country B Specialises in the Production of Wheat	Country B Specialises in the Production of Cloth
↓	↓
Export wheat Import cloth	Export cloth Import wheat

Point to be Noted

In 1936, Haberler introduced concept of opportunity cost

↓

The Nation with Lower opportunity cost has Comparative Advantage in that Commodity & Comparative disadvantage in Second Commodity

↓

There Fore

Export the Commodity with lower Opportunity cost & Import the Commodity with higher Opportunity cost

WHY?

There is comparative advantage in one & disadvantage in second resolved by ↓

The Heckscher - Ohlin Theory

Propounded by Hecksher & Ohlin
According to this theory basis of
International trade
is
Differences in Factor Endowment

Differences in Factor Endowment

Some countries are Labour Abundant whereas some are capital Abundant.

Product whose production use relatively Abundant Resources → Export

Product whose production use relatively scarce resources → Import

Country A	Country B
Capital Abundant	Labour Abundant

Country A (Capital Abundant) → Export Capital Intensive Goods

Country B (Labour Abundant) → Export Labour Intensive Goods

There Fore

Export the commodity Whose production Use Intensively the Factors Which are relatively Abundant

&

Import the commodity whose production use intensively the Factors Which are relatively Scarce.

Difference

Comparative Cost Theory	Modern Theory
Basis is comparative cost	Basis is difference in factor endowment
Based on labour cost	Based on money cost
Labour as sole factor	Labour & capital 2-factors
International trade is diff. from domestic trade	Special-case of inter regional trade
Study comparative cost	Relative price of factors
Diff. in productive efficiency	Diff. in factors endowments
Not consider factors price difference	Consider factor price differences
Does not provide cause of comparative advantage	Explain the difference in comparative advantage.
Normative approach	Positive approach

New International Trade Theory

Propounded by Paul Krugman
According to this theory basis of
International trade
is

Economies of Scale

&

Network effect

Firm Produce
More
When its cost per unit
going down.
So reap the benefits
of large scale
&
More profits; firms
Serve domestic
as well as
Foreign market.

It is the way
one person's value
for goods or service
affected
by
Value of G or S to
others.
Value of G & S
increases as the
number of individual
Using it increases.

eg:

Points to be Noted:

Krugman received Nobel Prize
For Economics for his work in economic geography
& international trade pattern
in 2008.
His Book "In praise of cheap labore" published in 1997.