UNIT - 1: THEORIES OF INTERNATIONAL TRADE

INTRODUCTION

- International trade is the exchange of goods and services as well as resources between countries.
- It involves transactions between residents of different countries. If there is a point on which most economists agree, it is that trade among nations makes the world better off.
- International trade is an integral part of international relations and has become an important engine of growth in developed as well as developing countries.

Benefits of International Trade

Boost

- Powerful stimulus to economic efficiency and contributes to economic growth and rising incomes. The wider market made possible owing to trade induces companies to reap the quantitative and qualitative benefits of division of labour.

- Efficient deployment of productive resources to their best use is a direct economic advantage of foreign trade. Greater efficiency in the use of natural, human, industrial and financial resources ensures productivity gains. Since international trade also tends to decrease the likelihood of domestic monopolies, it is always beneficial to the community.

- Trade provides access to new markets and new materials and enables sourcing of inputs and components internationally at competitive prices. This reflects in innovative products at lower prices and wider choice in products and services for consumers. It also enables nations to acquire foreign exchange reserves necessary for imports which are crucial for sustaining their economies.

- Trade also provides greater stimulus to innovative services in banking, insurance, logistics, consultancy services etc.

- 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.

- Opening up of new markets results in broadening the productive base and facilitates export diversification so that new production possibilities are opened up.

- Trade can also contribute to human resource development, by facilitating fundamental and applied research and exchange of know-how and best practices between trade partners.

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

Limitations -The major arguments put forth against trade openness

- International trade is often not equally beneficial to all nations. Potential unequal market access and disregard for the principles of a fair trading system may even amplify the differences between trading countries, especially if they differ in their wealth.

- Economic exploitation is a likely outcome when underprivileged countries become vulnerable to the growing political power of corporations operating globally. The domestic entities can be easily outperformed by financially stronger transnational companies.

- Substantial environmental damage and exhaustion of natural resources in a shorter span of time could have serious negative consequences on the society at large.

- Trade cycles and the associated economic crises occurring in different countries are also likely to get transmitted rapidly to other countries.

- Risky dependence of underdeveloped countries on foreign nations impairs economic autonomy and endangers their political sovereignty. Such reliance often leads to widespread exploitation and loss of cultural identity. Substantial dependence may also have severe adverse consequences in times of wars and other political disturbances.

- Too much export orientation may distort actual investments away from the genuine investment needs of a country.

- Finally, there is often a lack of transparency and predictability in respect of many aspects related to trade policies of trading partners. There are also many risks in trade which are associated with changes in governments' policies of participating countries, such as imposition of an import ban, high import tariffs or trade embargoes.

IMPORTANT THEORIES OF INTERNATIONAL TRADE

1) The Mercantilists' View of International Trade

- Mercantilism, which is derived from the word mercantile, "trade and commercial affairs". Mercantilism according to Microsoft Encarta Dictionary (2009), is the economic policy trending in Europe from the 16th to the 18th centuries.

- Government used power to control industry and trade with the theoretical belief that national power is achieved and sustained by having constant large quantities of exports over imports.

- Mercantilists also believed that the more gold and silver a country accumulates, the richer it becomes. Mercantilism advocated maximising exports in order to bring in more "specie" (money in the form of precious metals) and minimizing imports through the state imposing very high tariffs on foreign goods.

  Imp duty

- 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

  Available

- Nations' human and material resources are unevenly endowed, distributed and developed. This allows flow of labour, raw materials, capital and finished products across national boundaries and markets; thus resulting in "mercantilism".

A . +$10

B - $10

Exports > Import

Zero Sum Game

2) The Theory of Absolute Advantage

- Adam Smith was the first to put across the possibility that international trade is not a zero-sum game. He thought that the basis of international trade was absolute cost advantage.
- According to his theory, trade between two countries would be mutually beneficial if one country could produce one commodity at absolute advantage (over the other commodity) and the other countries could, in turn, produce another commodity at an absolute advantage over the first.
- In other words, the principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce a greater quantity of a good, product, or service than competitors, using the same amount of resources.
- Adam Smith first described the principle of absolute advantage in the context of international trade, using labour as the only input

- Absolute advantage exists between nations when they differ in their ability to produce goods. Each nation can produce one good with less expenditure of human labour or more cheaply than the other. As a result, each nation has an absolute advantage in the production of one good.

Absolute advantage can be explained with a simple numerical example:

Output per Hour of Labour 1hr. Ritne unit ₹100

Commodity	Country A	Country B
Wheat (~~bushels~~ unit/hour)	6 → Adv.	1 ✗
Cloth (~~yards~~ unit/hour)	4	5 - Adv.

As can be seen from the above table:

➡️ one hour of labour time produces 6 bushels and 1 bushel of wheat respectively in country A and country B.

➡️ On the other hand, one hour of labour time produces 4 yards of cloth in country A and 5 in country B.

📌 Country A is more efficient than country B, or has an absolute advantage over country B in production of wheat.

📌 Similarly, country B is more efficient than country A, or has an absolute advantage over country A in the production of cloth.

◾ 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.

[Labour hours P.u]

	A	B
Tea [Kg]	8	5 → Absolute adv.
Jeans [Qty]	2	4
	└ Abs. adv	

Assumptions of the Absolute Advantage Theory:

- Trade between the two countries.
- He took into consideration a two-country and two-commodity framework for his analysis.
- There is no transportation cost.
- Smith assumed that the costs of the commodities were computed by the relative amounts of labour required in their respective production processes.
- He assumed that labour was mobile within a country but immobile between countries.
- He implicitly assumed that any trade between 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.

3) The Theory of Comparative Advantage

- *David Ricardo* observed that trade was driven by comparative rather than absolute costs (of producing a good).
- One country may be more productive than others in all goods, in the sense that it can produce any good using fewer inputs (such as capital and labour) than other countries require to produce the same good.

- Ricardo's insight was that such a country would still benefit from trading according to its comparative advantage—exporting products in which its absolute advantage was greatest, and importing products in which its absolute advantage was comparatively less (even if still positive). Even a country that is more efficient (has absolute advantage) in everything it makes would benefit from trade. Consider an example:

Commodity	Country A	Country B
Steel (kg)	3	1
Shirts (units)	2	1

Country A: One hour of labour can produce either three kilograms of steel or two shirts.
Country B: One hour of labour can produce either one kilogram of steel or one shirt.
Country A is more efficient in both products.

■ Now suppose Country B offers to sell Country A two shirts in exchange for 2.5 kilograms of steel.

👉To produce these additional two shirts, Country B diverts two hours of work from producing (two kilograms) of steel.

👉Country A diverts one hour of work from producing (two) shirts. It uses that hour of work to instead produce three additional kilograms of steel.

Overall, the same number of shirts is produced: Country A produces two fewer shirts, but Country B produces two additional shirts.

However, more steel is now produced than before: Country A produces three additional kilograms of steel, while Country B reduces its steel output by two kilograms. The extra kilogram of steel is a measure of the gains from trade.

■ Though a country may be twice as productive as its trading partners in making clothing, if it is three times as productive in making steel or building aeroplanes, it will benefit from making and exporting these products and importing clothes.

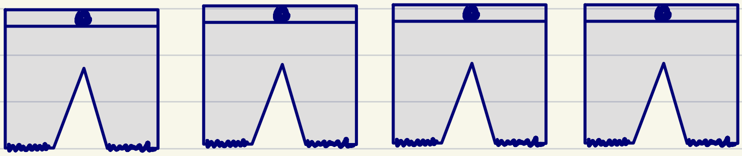
■ Its partner will gain by exporting clothes—in which it has a comparative but not absolute advantage—in exchange for these other products.
opp cost ↓

■ The notion of comparative advantage also extends beyond physical goods to trade in services—such as writing computer code or providing financial products.

■ Because of comparative advantage, trade raises the living standards of both countries. Douglas Irwin (2009) calls comparative advantage "good news" for economic development. "Even if a developing country lacks an absolute advantage in any field, it will always have a comparative advantage in the production of some goods," and will trade profitably with advanced economies.

Country A

unit / hour



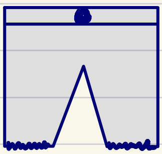
Chocolate Chocolate

Opp. cost

1 chocolate → 2 jeans

1 jeans → 0.5 chocolate

Country B



Chocolate

Opp. cost

1 chocolate - 1 jeans

1 jeans = 1 chocolate

Each person should produce the good for which there is a lower opportunity cost than other producers

→ Opportunity cost - Haberler

4) The Heckscher-Ohlin Theory of Trade - Modern Theory

- Factor Endowment Theory

■ In the early 20th century, Swedish economists Eli Heckscher and Bertil Ohlin identified the role of labour and capital, so-called factor endowments, as a determinant of advantage.

■ The Heckscher-Ohlin proposition maintains that countries tend to export goods whose production uses intensively the factor of production that is relatively abundant in the country.

👉Countries well endowed with capital—such as factories and machinery—should export capital- intensive products, while those well endowed with labour should export labour-intensive products.

■ The labour-abundant countries have comparative cost advantage in the production of goods which require labour-intensive technology and by the same reasoning; capital-abundant countries have comparative cost advantage in the production of goods that need capital-intensive technology.

Country

A - Abundant Labour → Goods Which require labour

B - Abundant cap → Goods Which require cap

Comparison of Theory of Comparative Costs and Modern Theory

Theory of Comparative Costs - Ricardo	Modern Theory - H.O
The basis is the difference between countries is comparative costs	Explains the $\boxed{\text{causes}}$ of differences in comparative costs as differences in factor endowments
Based on labour theory of value	Based on $\boxed{\text{money cost}}$ 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 2-factor model and can 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. Labour & cap
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

Should

what is - explains the diff

Globalization and New International Trade Theory

■ American economist and journalist Paul Krugman received the 2008 Nobel Prize for Economics for his work in economic geography and in identifying international trade patterns.

■ In the late 1970s, Paul Krugman noticed that the accepted model that economists used to explain patterns of international trade did not fit the data.

👉The Heckscher-Ohlin model predicted that trade would be based on such factors as the ratio of capital to labor, with "capital-rich" countries exporting capital-intensive goods and importing labor-intensive goods from "labor- rich" countries. But Krugman noticed that most international trade takes place between countries with roughly the same ratio of capital to labor.

This is particularly true in key economic sectors in India such as electronics, IT, food, and automotive. We have cars made in India, yet we purchase many cars made in other countries.

■ Krugman defended free trade. He was passionate and showed deep concern for the well- being of people around the world. One such example is "In Praise of Cheap Labor," published in Slate in 1997.

■ According to NTT, two key concepts give advantages to countries that import goods to compete with products from the home country:

👉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, then it can reap the benefit of large scale of production consequently the profits are likely to be higher.

👉**Network effects** refer to the way one person's value for a good or service is affected by the value of that good or service to others. 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'. Consumers like more choices, but they also want products and services with high utility, and the network effect increases utility obtained from these products over others. A good example will be Mobile App such as What's App and software like Microsoft Windows.

Unit over :)