Theories of International Trade

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International Trade

- *Exchange of goods, services & resources between countries.*
- *Involves transactions between residents of different countries.*
- *Transactions in multiple currencies.*
- *Involves greater complexity.*

→ *Important engine of growth for economies.*

Features of International Trade

- *Heterogeneity of consumers & currencies*
- *Differences in legal systems*
- *Elaborate documentation*
- *Diverse restrictions(taxes) & regulations*
- *Duties, tariffs, quotas*
- *Trade barriers*
- *Restraints to movement of specified goods & services.*
- *Transportation issues.*

Internal & International Trade

S.No.	Internal Trade	International Trade
1	Labour & Capital - mobile	Immobile factors of production
2	Complete adjustment to wage differences	Not so
3	Geographical patterns & climatic conditions – quite similar	Varies to a greater extent & specialise in the production of a certain product
4	Similar market conditions	Wide range of market conditions
5	Only geographical restrictions	Tariff & non-tariff barriers
6	Single currency	Multiple currencies
7	Absence of BOP problem	Presence of BOP problem
8	Low transport cost	High transport cost
9	Single political unit	Different political units
10	Similar economic environment	Diverse economic environment
11	Same policies (commerce, trade, taxation, etc…)	Varied national & economic policies

Arguments FOR

- *Stimulus to economic efficiency & contributes to economic growth & rising incomes – wider market owes quantitative & qualitative benefits – economies of large scale production – global competition – efficient deployment of productive resources – decreases domestic monopolies.*
- *Access to new markets & materials – wider variety of goods & services - innovative products at lower prices.*
- *Acquires foreign exchange reserves necessary for imports – crucial for sustaining their economies.*

Contd…

- *Enhances extent of market – scope for mechanisation & specialisation – supports technological change – stimulates innovation – facilitates greater investment in R&D, thus improving productivity.*
- *Job creation –reduces poverty – raises standards of living – increases overall demand for goods & services.*
- *Generates foreign investment (FDI)*
- *New production possibilities - broadening of product base – export diversification – maintain stability in prices & supply of goods.*
- *Human resource development – strengthens bonds between nations – mutually beneficial exchanges – promotes harmony & cooperation among nations.*

Arguments AGAINST

- *Negative labour market outcomes – depresses demand for unskilled workers.*
- *Economic exploitation – underprivileged countries become vulnerable to political power.*
- *Excessive stress on exports – profit-driven exhaustion & exploitation of natural resources.*
- *Change in patterns of demand – adverse effect on development of domestic industries – rapid transmission of economic crises.*
- *Risky dependence – impairs economic autonomy & political sovereignty – loss of cultural identity.*

Contd…

- *Welfare of people ignored for the sake of profit – excessive exports might cause shortages in exporting countries leading to high inflation – import of harmful products.*
- *Distorts actual investments away from genuine investment needs of a country.*
- *Might breed rivalry on account of severe competition.*
- *Lack of transparency & accountability relating to trade policies – risks w.r.t changes in political policies.*

Important Theories of International Trade

- The Mercantilists' View of International Trade
- The Theory of Absolute Advantage
- The Theory of Comparative Advantage
- The Heckscher – Ohlin Theory of Trade
- New Trade Theory (NTT)

The Mercantilists' View of International Trade

- ***Mercantilism*** *– policy of Europe's great power.*
- ***Basis*** *– increased export & precious metals in return.*
- ***Belief*** *– accumulation of more gold & silver – richer becomes a country.*
- ***Advocated*** *– maximising exports & minimising imports (through high tariffs)*
- ***Argument*** *– 'zero-sum game' – one country's gain = another country's loss.*

The Theory of Absolute Advantage

- *Propounded by – **Adam Smith***
- *Supported unrestricted trade & free international competition.*
- *Absolute cost advantage – determinant of mutually beneficial international trade.*
- *Theory – '<u>a country will specialise in the production & export of a commodity in which it has an absolute cost advantage i.e. at an absolutely lower production cost than the other country.'</u>*
- *Basis – principle of division of labour – value of goods is determined by measuring labour as an input.*

Contd…

***TWO** Countries **TWO** Commodities Model*

Output Per Hour of Labour		
Commodity	**Country A**	**Country B**
Wheat (bushels/hour)	**6**	1
Cloth (yards/hour)	4	**5**

What if Country A has absolute advantage in the production of both commodities and Country B has absolute disadvantage in the production of both commodities ???!

The Theory of Comparative Advantage

- *Propounded by –* ***David Ricardo – "Principles of Political Economy and Taxation" - 1817***
- *Theory – "even if one is less efficient than the other nation in the production of all commodities, there is still scope for mutually beneficial trade".*
- *Comparative advantage differences explained by exogenous factors.*
- *Ricardo's predictor of trade – comparative labour productivity.*

Contd…

TWO Countries TWO Commodities Model

Output Per Hour of Labour		
Commodity	**Country A**	**Country B**
Wheat (bushels/hour)	**6**	1
Cloth (yards/hour)	4	**2**

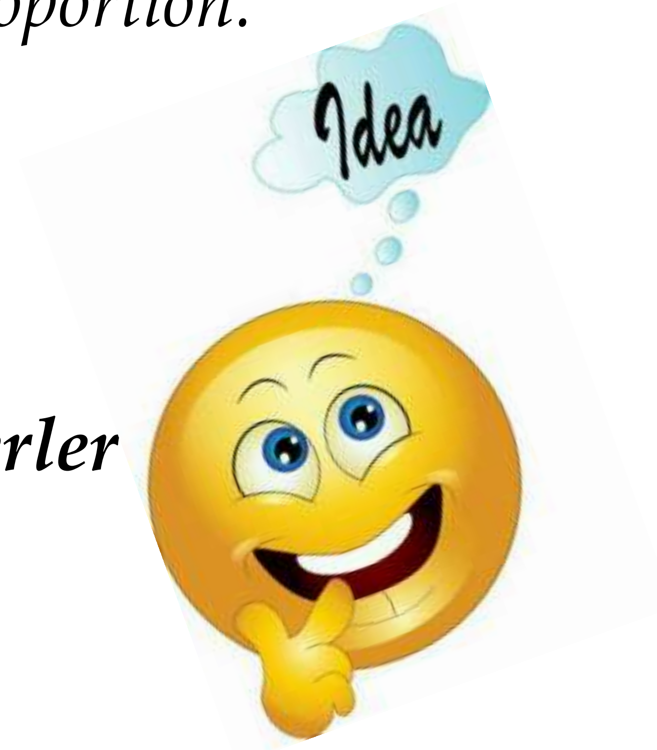
Both nations can gain if country A specialises in the production of wheat and exports some of it in exchange for country B's cloth. Likewise, country B should specialise in the production of cloth and export some of it in exchange of country A's wheat → gains are not likely to be equal.

Contd…

- *Basis – '**labour theory of value**' – value/price of a commodity depends on the amount of labour used in production.*

  - unrealistic as labour is not the only factor of production nor used in same proportion.

Haberler



Opportunity Cost

- *Haberler – 1936 – opportunity cost (OC)*
- *Opportunity cost – value foregone – 'real 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"*
- *OC of producing one unit of good X =*

$$\frac{\text{Amount of labour required to produce one unit of good } X}{\text{Amount of labour required to produce one unit of good } Y}$$

- *Nation with lower OC in the production of a commodity has a comparative advantage in that commodity.*

Contd…

- *International differences in relative factor-productivity are the cause of comparative advantage & country exports goods that it produces efficiently* => *complete specialisation in that product.*

***Criticisms**:*

- *Emphasis on supply & excludes demand patterns*
- *Fails to examine the reasons for different cost.*

Why does a nation have comparative advantage in the production of a commodity and comparative disadvantage in the production of another??!

Heckscher – Ohlin Theory of Trade

- *Eli Heckscher & Bertil Ohlin –* ***1933*** *– 'Inter-regional & International Trade'*
- *Factor Endowment Theory or Modern Theory of Trade.*
- ***H-O Model*** *– Two countries have different factor endowments under identical production function & identical preferences.*
- *Different factor endowments – different factor prices – different cost functions.*
- ***Theory*** *– "comparative advantage in cost of production is explained exclusively by the differences in factor endowments of the nations".*

Contd…

- *Factor endowment – overall availability of usable resources – only labour & capital taken into account.*
- *International trade is a special case of inter-regional trade.*
- *Different regions have different Factor endowments*
- *Different goods have different production functions i.e., factors of production are combined in different proportions to produce different commodities.*

→ *Hence, different regions have different capacity to produce different commodities.*

Therefore, difference in factor endowments is the main cause of international trade.

The Theory

- *Ohlin – "<u>the cause of difference in the relative prices of goods is the difference of the amount of factor endowments, like, capital & labour, between two countries</u>".*
- *Country's exports depend on its resources endowment*
- *Capital abundant country produces capital intensive goods as they have a comparative advantage in the production of goods that need capital intensive technology; vice versa.*
- *H-O theory are stated in two forms i.e., H-O Trade Theorem & Factor-Price Equalisation Theorem.*

Heckscher – Ohlin Trade Theorem

"A country tends to specialise 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".

Factor-Price Equalisation Theorem

- *International trade tends to equalise the factor prices between the trading nations.*
- *Theorem – "if the prices of the output are equalised between countries engaged in free trade, then the price of the input factors will also be equalised between countries".*
- *Implies that trade in goods is a perfect substitute for trade in factors i.e., product & factor mobility become perfect substitutes.*
- *H-O theorem – foreign trade eliminates the factor price differentials.*

New Trade Theory (NTT)

- *Developed in 1970s as a way to understand international trade patterns.*
- *Why developed & big countries are trade partners when they are trading similar goods & services??*
- *Eg: key economic sectors such as electronics, IT, food & automotive.*
- *Usually products that come from large, global industries that directly impact international economies, like, mobile phones, India produces them & also imports them.*

Contd…

- *NTT argues that because of substantial economies of scale and network effects, it pays to export phones to sell in another country. Those countries with the advantages will dominate the market, and the market takes the form of monopolistic competition.*

- *Two key concepts – Economies of Scale & Network Effects.*

Contd…

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.*

Network Effects *– the way one person's value of a good or service is affected by the value that good or service to others. The value of that product/service is enhanced as the number of individuals using it increases – referred to as '<u>bandwagon effect</u>'. Eg: Whatsapp*