Chapter 4 Unit I
Theories of International Trade

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Difference between Internal Trade External Trade

- Trade beyond geographical limits of a country
- Different countries involved
- Differences in monetary units or currencies
- Exchange rate risks

Difference between Internal Trade External Trade –Contd-

- Complex procedures and formalities
- Mode of payment (bill of exchange , letter of credit or by bank) .
- International laws rules & regulations
- Mode of transport

Difference between Internal Trade External Trade –contd-

- Immobility of factors of production
- High operating cost due to long distance
- Protectionism is practiced
- Effect on foreign reserves

Difference between Internal Trade External Trade -contd

- Customer heterogeneity across the market
- Differences in business practices
- Differences in political system
- Greater interference by government
- Vague business environment

Difference between Internal Trade External Trade -contd

- Restrictions on movement of goods and services
- Complex documentation
- Compulsory insurance
- Relatively higher risk
- Uncertain demand

Why liberal International Trade?

- Stimulus to economic efficiency
- Contributes to economic growth and rising incomes

Wider market

- Quantitative and qualitative benefits of extended division of labour
- Benefit from economies of large scale production.

Increased competition

- Adoption of cost reducing technology and business practices
- Efficient deployment of productive resources to their best uses
- Greater efficiency in the use of natural, human, industrial and financial resources
- Decrease the likelihood of domestic monopolies

Productivity gains

- Access to new markets and new materials
- Enables sourcing of inputs and components internationally at competitive prices.
- Innovative products at lower prices
- Wider choice in products and services for consumers.

- **Secure foreign exchange reserves necessary for imports**
- **Augments the scope for mechanization and specialisation**

- **Increased use of automation**
- **Supports technological change, stimulates innovations**
- **Greater investment in research and development and productivity improvement in the economy**

Exports stimulate economic growth

- By creating jobs
- Reducing poverty
- Augmenting factor incomes
- Raising standards of livelihood and
- Overall increase in demand for goods and services.

- **Greater stimulus to innovative services in banking, insurance, logistics, consultation etc**
- **Employment generating investments, including foreign direct investment inevitably follow trade.**

- **Improvement in the quality of output of goods and services**
- **Finer labour and environmental standards etc**
- **Enhance the value of products and enable them to move up the global value chain.**

- **Broadening of productive base**
- **Facilitates Export diversification**
- **Gainfully dispose off surplus output**
- **Prevent undue fall in domestic prices caused by overproduction**

- **Maintain stability in prices and supply of goods during periods of natural calamities**
- **Contributes to human resource development,**
- **Facilitates fundamental and applied research and exchange of know-how and best practices**

Above all

- Strengthens bonds between nations by bringing citizens of different countries together

Demerits

- Economic exploitation
- Domestic entities can be easily outperformed
- Excessive stress on exports
- Unsustainable production

- **Even an efficient company may be ousted by an overseas rival with a predatory pricing strategy**
- **Some efficient industries may find it difficult to compete for long periods under such conditions.**

- International markets are not a level playing fields
- Favour of foreign goods threaten the survival of infant industries
- Countries with surplus products may dump them
- New industries may find it difficult to enter and establish if foreign competitors already enjoy economies of scale and easy access to domestic markets.

Agricultural economies

- Face unfavourable terms of trade (ratio of export prices to import prices)
- Whereby their export income is much smaller than the import payments they make for high value added imports,
- Leading to large cads and
- Subsequently large foreign debt levels.

- **Profit-driven exhaustion of natural resources**
- **Substantial environmental damage**
- **Possible shift towards a consumer culture**
- **Change in patterns of demand in favour of foreign goods /services**

- **Trade cycles likely to get transmitted**
- **Risky dependence of underdeveloped countries**
- **Impairs economic autonomy and endangers their political sovereignty.**
- **Widespread exploitation and loss of cultural identity**

- **Welfare of people may be ignored or jeopardized for the sake of profit.**
- **Cause shortages and inflation**
- **Lack of transparency and predictability in respect of many aspects related to trade policies of trading partners.**

- **Excessive exports**
- **Import of harmful products**
- **Too much export orientation may distort actual investments away from the genuine investment needs of a country**
- **May breed rivalry on account of severe competition**

Discuss

Free action of market forces can be unprofitable for the less developed countries.

Theories of international trade

- The mercantilists' view of international trade
- Maximize exports in order to bring in more "specie"
- Minimize imports by imposing very high tariffs on foreign goods.
- Trade is a 'zero-sum game',

The Theory of Absolute Advantage

- Adam smith
- International trade is not a zero-sum game.
- Absolute cost advantage is the determinant of mutually beneficial international trade

- **A country will specialize in the production and export of a commodity in which it has an absolute cost advantage**
- **Absolutely lower production cost**

- **The principle of division of labour**
- **Value of goods is determined by measuring the labour incorporated in them.**
- **Hypothetical two countries and two commodities model (2x2 model).**

Output per Hour of Labour

Commodity	Country A	Country B
Wheat (bushels/hour)	6	1
Cloth (yards/ hour)	4	5

- country A would specialise completely in production of wheat and
- country B would specialise completely in cloth.

Trade – For Country A

- Country A exchanges six bushels of wheat (6W) for six yards of country B's cloth (6C)
- 6W =6C
- Domestic Exchange
- 6W = 4C
- Gain 2C = saves half an hour or 30 minutes of labour time

6W that country B receives from country A

- Require six hours of labour time to produce in country B
- These same six hours can produce 30C in country B (6 hours x 5 yards of cloth per hour)
- Country B gains 24C,(30-6) or saves nearly five hours of work.

Outcome

- Both countries can produce larger quantities of commodities which they specialize in.
- If they specialise but do not trade freely country A's consumers would have no wheat, and country B's consumers would have no cloth

A second case

- What happens if
- Country A has absolute advantage in the production of both commodities
- Country B has absolute disadvantage in the production of both commodities
- There is still scope for mutually beneficial trade

Output per Hour of Labour

Commodity	Country A	Country B
Wheat (bushels/hour)	6	1
Cloth (yards/hour)	4	2

Country B has a comparative advantage in Cloth.

- **B's labour is only half as productive in cloth but**
- **Six times less productive in wheat compared to country A**
- **(4:2) cloth (6:1) wheat**

Country A

- Has a comparative advantage in production and exporting **wheat.**
- The absolute advantage is greater in **wheat**
- Wheat (6:1) cloth (4:2),

Outcome for Country A

- **Country A's absolute advantage is greater in wheat**
- **Country A has a comparative advantage in producing and exporting wheat.**
- **Country A specialise in wheat, and exports some in exchange for country B's cloth**

Outcome for Country B

- Country B’s absolute disadvantage is smaller in **cloth**
- its **comparative advantage** lies in **cloth** production.
- B should specialise in **cloth** and export some of it in e**xchange** for country A’s wheat

Both nations can gain from trade

- Country A - 6W for 6C from B
- A gain 2C (= half an hour of labour)
- Country B gets 6W
- Six hours of labour time to produce in country B
- B can use the 6 hours for cloth = 12C ,exchange 6 C
- Gain is 6C (= 3 hours of labour)

Other possibilities

- Any thing above 4 C (Cloth) would be a gain for A
- In country B, 6W = 12C
- Country B gains to the extent that it can give up less than 12C for 6W from country A

The Heckscher-Ohlin Theory of Trade

- Heckscher-Ohlin
- (H-O) model
- Factor-Endowment Theory of Trade
- Modern Theory of Trade,
- Heckscher-Ohlin-Samuelson theorem.

Factor endowment

- Overall availability of usable resources including both natural and man-made means of production
- Only the two most important factors—labour and capital—are taken into account

Two countries

- Have different factor endowments
- Identical production function
- Identical preferences
- Different factor prices in the beginning.
- Have different cost functions.

Note

- Comparative advantage in cost of production is explained exclusively by the differences in factor endowments of the nations.

Reason for trade

- Difference in factor endowments
- Capital abundant
- Labour abundant
- Exports depend on endowment of resources

Two theorems

- Heckscher-Ohlin Trade Theorem and
- Factor-Price Equalization Theorem.

The Heckscher-Ohlin Trade Theorem

- A country tends to specialize in the export of a commodity whose production requires intensive use of its abundant resources
- Imports a commodity whose production requires intensive use of its scarce resources.

The ‘Factor-Price Equalization’

- International trade tends to equalize the factor prices between the trading nations
- International trade equalizes the absolute and relative returns to homogenous factors of production and their prices.

- **If the prices of the output of goods are equalized between countries engaged in free trade, then the price of the input factors will also be equalised**
- **Foreign trade eliminates the factor price differentials.**

For example

- When there is more demand for labour intensive goods
- The expanding labour intensive industry absorbs relatively more labour than the amount released by the contracting capital goods industry

- **The price of labour goes up,**
- **Its relative price increases,**
- **The relative price of capital declines**

- **When the prices of the output of goods are equalized between countries as they move to free trade,**
- **Then the prices of the factors (capital and labour) will also be equalized between countries.**
- **Product mobility and factor mobility become perfect substitutes.**

New Trade Theory (NTT)

- Explains why developed and big countries are trade partners when they are trading similar goods and services.
- Economies of Scale:
- Network effects
- ‘bandwagon effect’