INTERNATIONAL TRADE THEORIES

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SALIENT FEATURES OF INTERNATIONAL TRADE.

- Immobility of factors of production.
- Differences in natural resources.
- Different National policies.
- Differences in the geographical and political factors.
- Differences in monetary units.
- Degree of competition.

CLASSICAL THEORY OF INTERNATIONAL TRADE.

- **Assumptions** made in this theory are…

a. There are two countries producing two goods.
b. The size of economies of these countries is equal
c. There is perfect mobility of factors of production within countries
d. Transportation cost is ignored
e. Before specialization, country's resources are equally divided to produce each good

INTERNATIONAL TRADE THEORY

INTERNATIONAL TRADE THEORIES are the theories that explains international trade. It justifies, why a company does international trade.

CLASSICAL THEORIES

Mercantilism states that country should grow its reserves of gold and silver by encouraging exports and discouraging imports.

Absolute Advantage focuses on the concept that country should produce an item that it can manufacture more proficiently than other countries.

Comparative Advantage says that business can take place even if one nation has an advantage in making both items.

Heckscher-Ohlin Theory maintain that company should focus on producing item that uses factors of production available in abundance in that country.

Leontief Paradox is based on the observation that US was importing more of capital-intensive goods, and was exporting more of labor-intensive items.

MODERN THEORIES

Country Similarity Theory states that people in countries that are in the same level of development have similar preferences.

Product Life Cycle Theory says there are three stages in every product life cycle - new product, maturing product, and standardized product.

Global Strategic Rivalry Theory focuses on how companies can get competitive advantage when competing against global firms in same industry.

Porter's National Competitive Advantage Theory says that competitiveness business segment depends on innovative items, processes etc.

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Theory of mercantilism

The theory of mercantilism holds that countries should encourage export and discourage import. It states that a country's wealth depends on the balance of export minus import. According to this theory, government should play an important role in the economy for encouraging export and discouraging import by using subsidies and taxes, respectively.

Absolute Advantage

Ability of a nation to produce a good more efficiently than any other nation (greater output using same or fewer resources)

Riceland

1 resource unit = 1 ton rice *or* 1/5 ton tea

Tealand

1 resource unit = 1/6 ton rice *or* 1/3 ton tea

Specialization and trade allows each to produce and consume more

Theory of Comparative Advantage

- Comparative advantage is where a nation is able to produce a product at a lower opportunity cost. In other words, a nation sacrifices less of Good A to produce Good B than other nations. This is in sharp contrast to absolute advantage because a nation can have a comparative advantage but not actually be more efficient than other countries.
- The law of comparative advantage was originally introduced by David Ricardo back in 1817. He defined it as a state by which one nation was more efficient at producing a certain good than another. However, unlike absolute advantage, comparative advantage considers opportunity cost.

Comparative Advantage Illustrated

	Rice	Wheat
India	100 1 Rice = 2 Wheat	200 1 Wheat = .5 Rice
Bangladesh	80 1 Rice = 1.25 Wheat	100 1 Wheat = .8 Rice

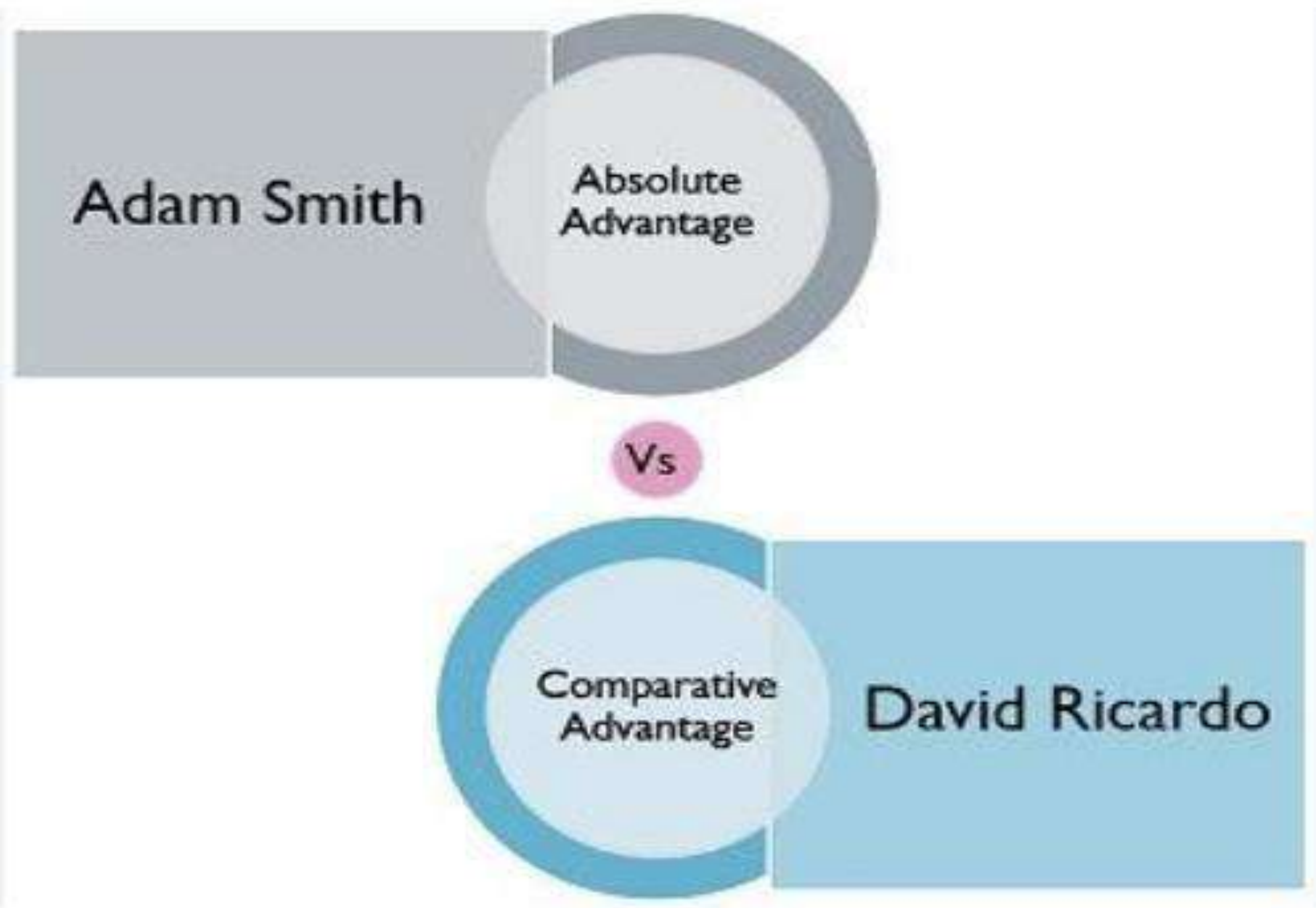
- India and Bangladesh produce both wheat and potatoes.
- India can produce either 200 kilograms of wheat or 100 kilograms of Rice
- As a result, 200kg of wheat = 100kg of Rice
- So for each 1kg of Rice, India must forego 2kg of Wheat.
- The opportunity cost is therefore what the nation foregoes to produce the other product.
- So its opportunity cost of producing Rice would be 2 ÷ 1 = 2.
- By contrast, the opportunity cost of producing Wheat is much smaller: 1 ÷ 2 = 0.5.
- By contrast, Bangladesh can produce either 80 kilograms of Rice or 100 kilograms of Wheat.
- So 80kg of Rice = 100kg of Wheat.
- And for each 1kg of Rice, Bangladesh must forgo 1.25 kg of Wheat.
- Therefore, the opportunity cost to Bangladesh of producing Rice would be 1.25 ÷ 1 = 1.25
- By contrast, the opportunity cost of producing Wheat is 1 ÷ 1.25 = 0.8

Identifying Comparative Advantage

- The table above depicts that India has an absolute advantage in producing both Wheat and Rice. However, which country has a comparative advantage?
- We can tell this by first looking at the product and then comparing the opportunity cost to each country. So in this example, the opportunity cost of making Rice in India is 2 Wheat. By contrast, it is only 1.25 in Bangladesh. **Therefore, the country that has the lowest opportunity cost has the comparative advantage.** So in this case, India would have the comparative advantage in Wheat production and should focus on this.
- If we now look to the production of Wheat, India has an opportunity cost of 0.5. In other words, it must sacrifice 0.5 Rice. At the same time, Bangladesh has an opportunity cost of 0.8. So when we look at the nation with the lower opportunity cost, it would be India that has the comparative advantage. **Therefore, India should focus on producing Wheat, whilst Bangladesh focuses on Rice.**

Comparative Advantage: Definition, How to Calculate & Examples

- https://boycewire.com/comparative-advantage-definition/


Adam Smith
Absolute Advantage
Vs
Comparative Advantage
David Ricardo

Absolute Cost Advantage vs Comparative Cost Advantage

More Information Online WWW.DIFFERENCEBETWEEN.COM

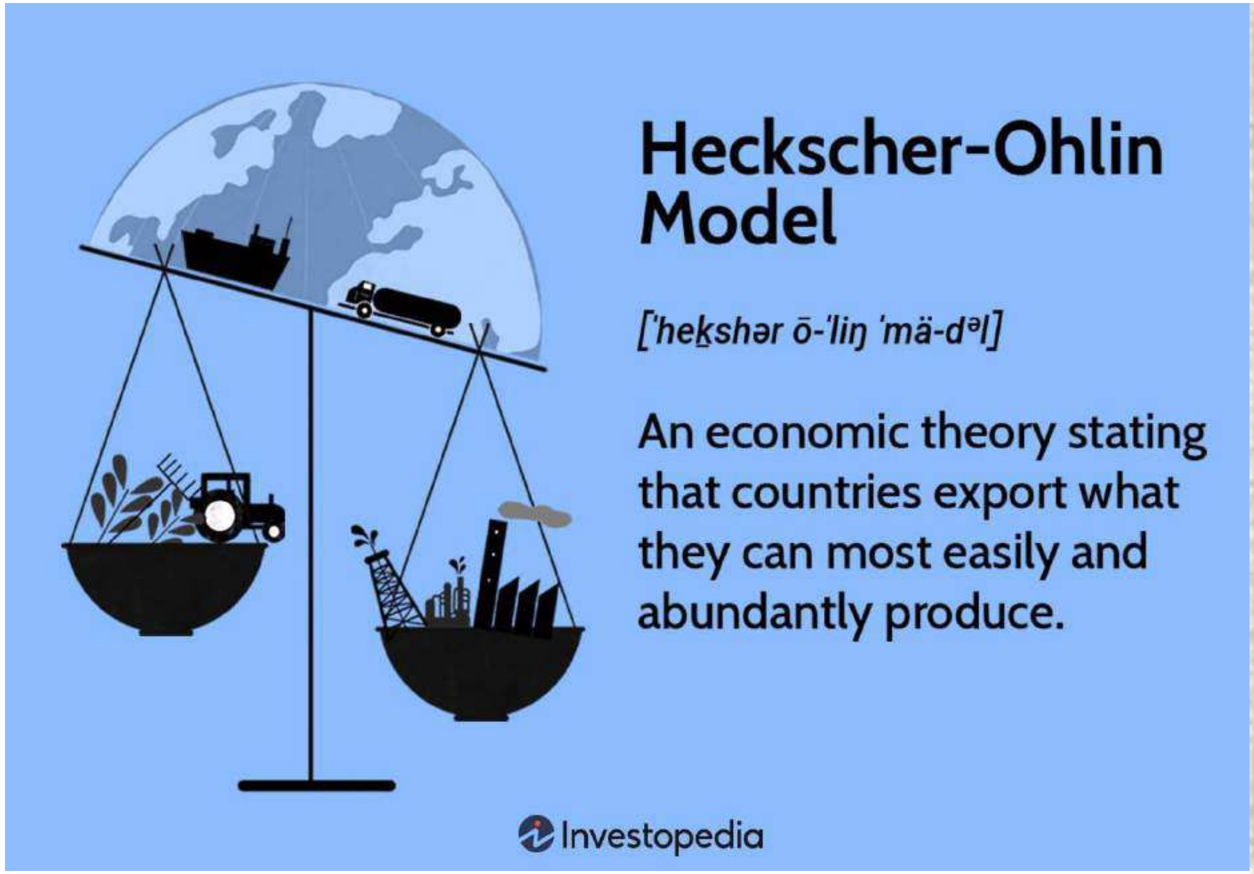
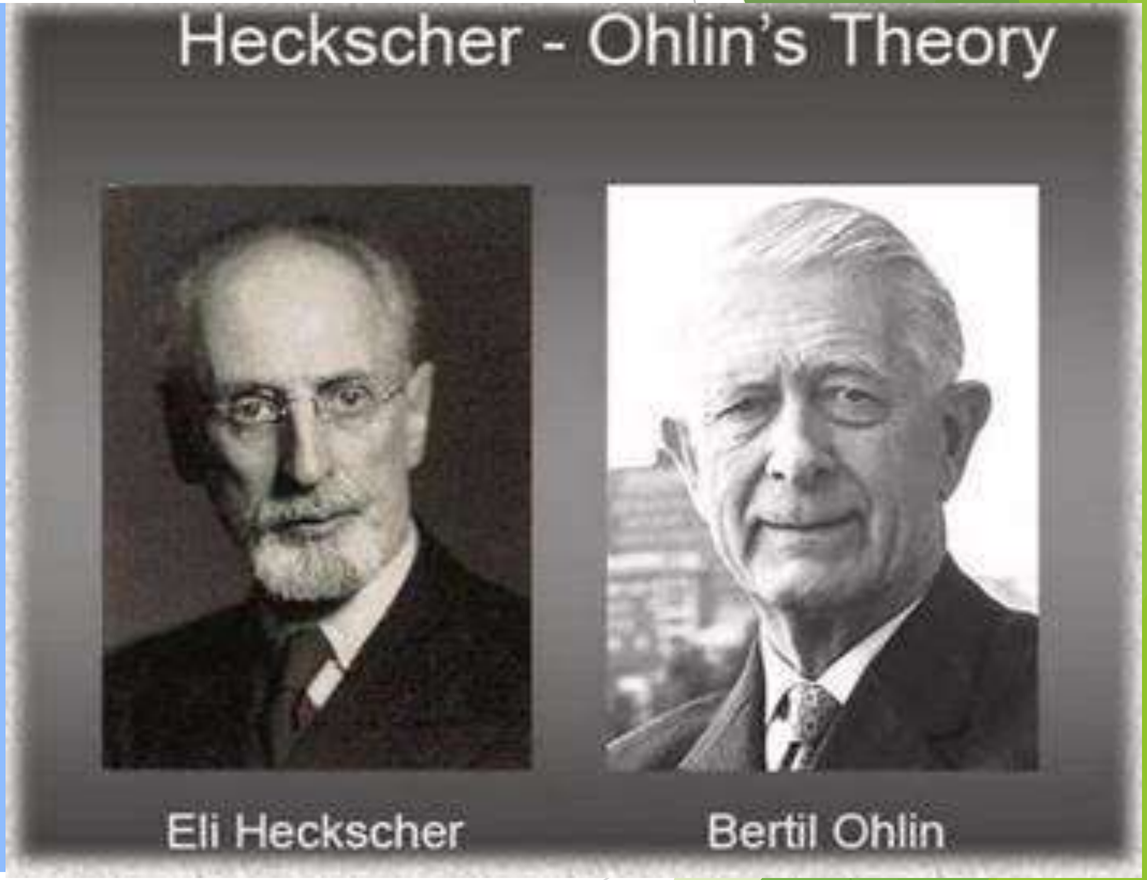
	Absolute Cost Advantage	Comparative Cost Advantage
DEFINITION	The ability of a country to manufacture more items with the same amount of resources than another country	The ability of a country to manufacture better items than another country with the same amount of resources
PRODUCTION	Trade is not mutually beneficial	Trade is mutually beneficial
COST	The absolute cost of manufacturing products impacts the absolute advantage a country has	The opportunity cost of manufacturing products impacts the country's comparative advantage
ECONOMIC NATURE	It is not mutual and reciprocal	It is mutual and reciprocal

Factor Endowment and Heckscher-Ohlin Theory

- In 1919 Eli Heckscher published "The Effect of Foreign Trade on the Distribution of Income" .
- In 1933 Berlin Ohlin published "Interregional and International Trade" in which he clarified and built on the work of Heckscher.
- The H-O theory can be presented in the form of two theorems: the H-O theorem (which deals with and predicts the pattern of trade) and the factor-price-equalization theorem (which deals with the effect of international trade on factor prices).

Heckscher- Ohlin Theory

- Definition: A nation will export the commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and import the commodity whose production requires the intensive use of the nation's relatively scare and expensive factor.
- Or: the relatively labor-rich nation exports the relatively labor-intensive commodity and imports the relatively capital -intensive commodity.
- This means that Nation 1 exports X because X is the L-intensive commodity and L is relatively abundant and cheap factor in Nation 1.

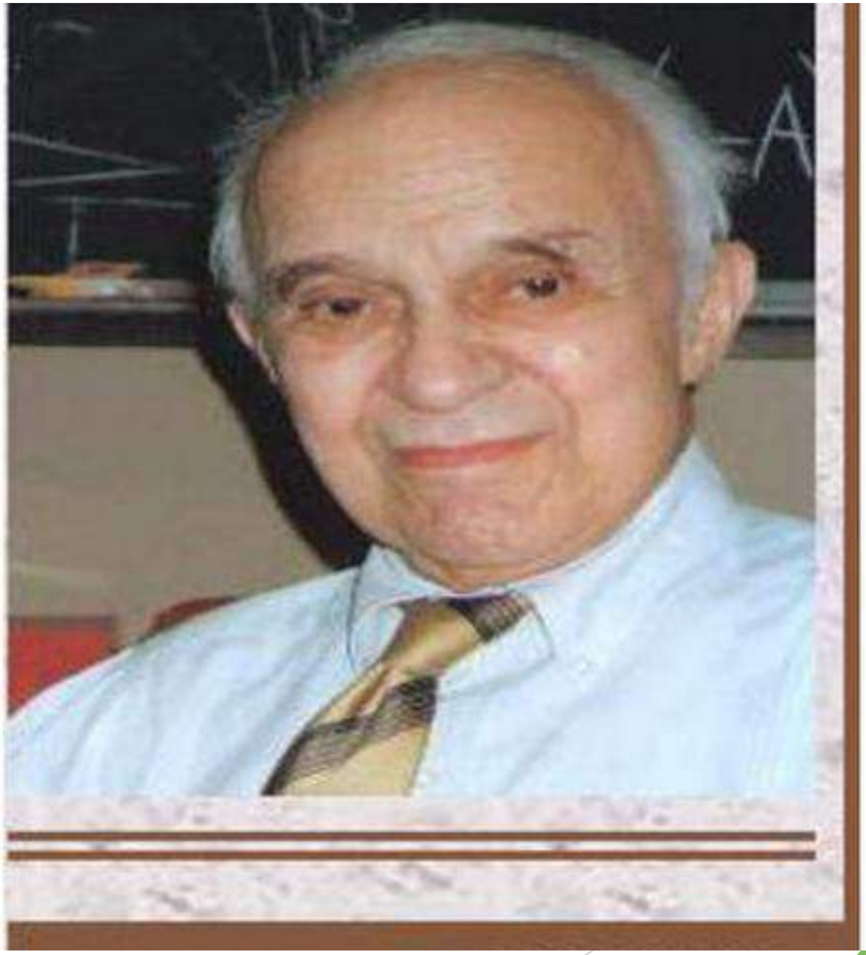

Heckscher-Ohlin Model
['hekshər ō-'liŋ 'mä-dᵊl]
An economic theory stating that countries export what they can most easily and abundantly produce.
Investopedia

Heckscher - Ohlin's Theory
Eli Heckscher
Bertil Ohlin

Important assumptions in the HO model

1. Two nations, two commodities and two factors of production
2. Identical technology in production
3. One commodity is labour intensive in production and the other is capital intensive in production
4. Constant returns to scale in production
5. Incomplete specialisation
6. Tastes are equal in both nations
7. Perfect competition in goods and factor markets
8. Factors of production are mobile nationally, but immobile internationally
9. No transport costs or other barriers to trade
10. Trade is balanced

Wassilly Leontief (1906-1999) Nobel Prize in 1973

- Does the H-O model actually explain trade patterns ?
- Leontief assumed and tested
  - The US is well endowed with capital
  - The US should export capital intensive goods and import labour intensive goods
  - The opposite appeared to be true – hence the Leontief paradox




Economy
Society
Sustainable
Development
Environment


Any
questions


Thank You!