INTERNATIONAL TRADE

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INTERNATIONAL TRADE

- International trade is the exchange of commodities and services beyond the geographical boundaries of nations.

- The core of international economic relationship comprises the exchange of goods and services between different independent or sovereign states or countries in the world.

INTERNATIONAL TRADE

- According to Ohlin, “Regions and nations specialize and trade with each other for the same reasons that individuals specialize and trade.”

- “International trade is only a special case of inter-regional trade.

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.

- Adam Smith and David Ricardo gave the classical theories of international trade.

- The classical theories are divided into three theories :-

i) Theory of Mercantilism.

ii) Theory of Absolute Advantage.

iii) Theory of Comparative Cost Advantage.

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

CLASSICAL THEORY OF INTERNATIONAL TRADE.

- **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.

CLASSICAL THEORY OF INTERNATIONAL TRADE.

- **Theory of Absolute Advantage :-**

Adam Smith gave the theory of absolute advantage stated that a country should specialize in those products, which it can produce efficiently. This theory assumes that there is only one factor of production that is labor.

In his words “If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage”.

CLASSICAL THEORY OF INTERNATIONAL TRADE.

- **Theory of Comparative Cost Advantage :-**

David Ricardo in his theory of comparative advantage states that trade can be beneficial for two countries if one country has absolute advantage in all the products and the other country has no absolute advantage in any of the products.

A nation, like a person, gains from the trade by exporting the goods or services in which it has its greatest comparative advantage in productivity and importing those in which it has the least comparative advantage. ”

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CLASSICAL THEORY OF INTERNATIONAL TRADE.

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- **Theory of Comparative Cost Advantage :-**

  This theory assumes that labor is the only factor of production in two countries, zero transport cost, and no trade barriers within the countries.

CRITICISM OF THE CLASSICAL THEORY.

1. This theory assumes that labor is the only factor of production and it ignores the other factors such as Land, Capital and enterprise etc.
2. Theory is based on the assumption of full employment, therefore it is unrealistic.
3. Labor is not perfectly mobile in a country, especially like India with its different languages, cultures and climates. Further , workers in construction industry cannot move to IT industry with ease.
4. A theory cannot be based on constant returns. In this dynamic world technological advances are increasing productivity effectively. The theory assumes no such changes and seems to be unrealistic.
5. Movement of goods from country to country involves significant transport costs. These are ignored by the theory. Free trade assumed by the theory is incorrect.

CRITICISM OF THE CLASSICAL THEORY.

6. The theory fails to take into account time element for storage and ignores interest cost.
7. The theory ignores the cost of transport, which is an important factor in determining the cost ratio. Such costs effect the flow of goods from one country to the other.
8. The theory is based on two countries two commodities case while realistically international trade is multidimensional and involves more countries.

OPPORTUNITY COST APPROACH

The opportunity cost theory explains that if a country can produce either commodity X or Y, the opportunity cost of commodity X is the amount of the other commodity Y that must be given up in order to get one additional unit of commodity X. Thus, the exchange ratio between the two commodities is expressed in terms of their opportunity cost. The concept of opportunity costs has been illustrated in international trade theory with production possibility curve.

OPPORTUNITY COST APPROACH - ASSUMPTIONS

- There is perfect competition in factor and commodity markets.
- Price = Marginal cost of production for every commodity.
- Factor price = Marginal product of the factor.
- There is condition of full employment equilibrium.
- Supply of factors is fixed.

OPPORTUNITY COST APPROACH – CRITICAL ANALYSIS.

The opportunity cost theory analyses pre-trade and post-trade situation under constant, increasing and decreasing opportunity costs whereas the comparative cost theory is based on the constant costs of production within a country and comparative advantage and disadvantage between the two countries. Thus, the opportunity cost theory is superior to the classical comparative cost theory on analytical grounds. According to Jacob Viner, the opportunity cost approach is inferior as tool of welfare evaluation to the classical real cost approach. Despite these criticisms, the opportunity cost approach has been regarded as a simplified version of a general equilibrium model by Richard Caves. As pointed out by Samuelson "the opportunity cost approach is more fertile because it can be readily extended into a general equilibrium system.

MODERN THEORY – HECKSCHER-OHLIN APPROACH

- Every country has different factor endowments, thus the costs of these factors differ depending upon their availability. For example, if a country has abundant labor, then the cost of labor would be low in that country.
- According to Heckscher and Ohlin theory, a country would export products, which it produces by using the abundant factor of production. However, it would import goods, which require use of scarce resources. Countries trade with each other because they have different factor endowments.
- For instance, some countries may have more labor and less machinery and some may have more machinery and less labor. In such a case, the country with more labor would specialize in labor-intensive products and export those products to other country.

MODERN THEORY – ASSUMPTIONS

a. Needs of citizens of the two countries are same

b. Transportation cost between the countries is zero

c. Factors of production in both the countries are immobile

d. Factors of production in both the countries are not available in same proportion

MODERN THEORY – CRITICISM

- **Oversimplified Assumptions** :-This theory is based upon highly over-simplifying assumptions of perfect competition, full employment of resources, identical production function, constant returns to scale, absence of transport costs and absence of product differentiation. Given this set of assumptions, the whole model becomes quite unrealistic.
- **Partial Equilibrium Analysis** :- Haberler although recognized Ohlin's theory as less abstract, yet it has failed to develop a general equilibrium concept. It remains, by and large, a part of the partial equilibrium analysis. This theory seeks to explain the pattern of trade only on the basis of factor proportions and factor intensities, while ignoring several other influences such as transport costs, economies of scale, external economies etc., which too exert influence on the cost of production.

MODERN THEORY – CRITICISM

- **Neglect of Product Differentiation** :- The theory overlooks the role played by product differentiation in international trade. Even when the production agents are identical in two countries, the international trade may still take place due to product differentiation.
- **Factor Proportions and Specialization :-** The theory suggests that the relative factor proportions (or factor endowments) determine the specialization in exports of different countries. The capital-abundant countries export capital-intensive goods and labor-abundant countries export the labor-intensive goods. It implies that trade will not take place between such countries or regions as have similar relative factor proportions. But this is not true.

MODERN THEORY – CRITICISM

- **Neglect of Factor Demand** :- The theory assumes that the factor prices are determined by the relative factor endowments of a country. It means the rate of interest should be relatively low and wage rates relatively high in a capital-abundant but a labor-scarce country. The theory fails to take into account the influence of demand for factors on their prices.
- **Factor Mobility** :- This theory assumes that there is absence of international mobility of factors. This assumption is not valid.