THEORIES OF INTERNATIONAL TRADE

INTRODUCTION

- Exchange of goods and services across national borders is known as international trade.
- International trade is as old as the human civilization.
- Development of transport and communication and international currency market help in the growth of international trade.
- Differences in the endowment of natural resources and specialization lead to international trade.
- The classical trade theories focus on absolute and comparative advantage as the determinant of international trade.
- Recent developed trade theories explain links among natural country advantages, government action and industry characteristics, which enables international trade.

CLASSICAL TRADE THEORIES

- Classical trade theories believed in free trade policy.
- There should not be any restrictions or barriers in world trade.
- Only free trade can improve the world trade.
- Both goods, services, human specialization should be allowed freely without any restriction.

MERCANTILISM

- International trade cannot benefit two countries at the same time.
- One country would be the loser always in trade.
- In the earlier days, dating back to the 16-18th century, Mercantilism was the economic philosophy that maintained that a country’s wealth is measured by its holding of gold and silver.
- Probably, it is this philosophy that earned India the name ‘golden bird’ in ancient times.
- According to the principles of mercantilist theory, a country’s goal should be to enlarge those holdings, i.e. the assets in the form of gold and silver.
- In order to increase the gold in the country, it was believed that money should come in to the country and not go out of it.

- Therefore, mercantilism suggests that the ruling government should advance these goals by protectionist role in the economy by encouraging exports and discouraging imports, notably through the use of subsidies and tariffs respectively.
- The century dominated Western European economic policies from the 16th to the late 18th century.
- That was the time of colonialism and the nations concentrated on capturing the colonies, exploiting them for raw materials and selling them back finished goods.
- There was no move to sell the goods between nations.

ABSOLUTE COST ADVANTAGE

- Adam Smith in 1776 in his book the Wealth of Nations, described about international trade on the basis of Absolute Cost Advantage.
- A country should specialize in production of and export products for which it has absolute advantage
- Import other products where it does not have absolute cost advantage.
- In other words, exchange of goods between two countries will take place only if each of the two countries can produce one commodity at an absolutely lower production cost than the other country.
- This leads to productive utilization of resources and country would be beneficial in particular goods in the world market.

COMPARATIVE ADVANTAGE

- David Ricardo in his book Principles of Political Economy and Taxation, 1817 described about comparative cost advantage as the basis of world trade.
- Country should specialize in the production of those goods in which it is relatively more productive, even if it does not have absolute advantage in its production.

	Hours required to produce 1 unit of	Country A	Country B	
Absolute Disadvantage	Fruit juice	20	16	Absolute Advantage
Absolute Disadvantage	Cloth	20	8	Absolute Advantage

- Even if the one country has an advantage in production of both the commodities, still its possible for both the countries to trade.
- From the table mentioned above, it is clear that **Country A** requires 20 hours to produce 1 unit of juice, similarly **Country B** requires 16 hours to produce the same.
- At the same time, amount of time taken to produce 1unit of cloth is 20 hours by the **Country A,** whereas **Country B** requires only 8 hour to produce 1 unit of cloth.

Country A	**1 unit of Fruit Juice**	**20**
	1 unit of Cloth	20
	Total	40 hours

- **COUNTRY A-** So if we put a constraint that there are only 20 hours, in that case Country A can only produce 1 Unit of Fruit Juice and it cannot produce cloth.
- So, in that case 1 unit of fruit juice will have opportunity cost of 1 unit of cloth.
- Here, the Country A can produce either 1 unit of juice or 1 unit of cloth, therefore it will be comparatively cheaper to produce juice when compared among the two countries.

Country B	**1 unit of Fruit Juice**	**16**
	1 unit of Cloth	**8**
	Total	**24 hours**

- **COUNTRY B-** With 20 hours in hand, Country B can produce 1 unit of Fruit juice but, if at all it choses to produce 1 unit of fruit juice it gets 4 hours in balance. But, in that remaining 4 hours, it cannot produce 1 unit of cloth. So basically when the Country B choses to produce juice it definitely refuses to produce cloth.
- In the second situation if Country B choses to produce cloth, it has 20 hours and in that time it can produce 2 units of cloth, still it has 4 hour in balance, in which it cannot produce 1 unit of juice.
- So here in this case Country B can produce either 1 unit of juice or 2 units of cloth.
- Therefore for Country B it is costly to produce juice.
- When the countries decide the trade, then the time taken would be:
- 20 (hours) x 2(units of juice)=40 hours
- 8 (hours) x 2 (units of cloth)= 16 hours
- So the total time required= 56 hours
- Therefore it would be beneficial to produce for 56 hours for trade amongst both the countries, keeping in mind the comparative advantage.

Heckscher (1919)- Ohlin (1933)

- Factors Endowment Theory
- The amount of labour, land, money and entrepreneurship that could be exploited for manufacturing within a country. Countries with large factor endowments are often financially better off than countries with less factor endowments.
- Difference in factor endowments determine the pattern of trade.
- Countries are not equally endowed with natural resources and factors of production.
- Some are endowed with cheap labour while some are endowed with capital resources.

The Heckscher-Ohlin theory of foreign trade can be stated in the form of two theorems namely

- **1) Trade Theorem**
- Labour endowed countries would produce labour intensive goods and capital intensive countries produce capital intensive goods.
- In other words, this theorem establishes that a country tends to specialize 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.
- The degree and nature of factor endowment decides the pattern of international trade.

- **2) Factor Price Equalization Theorem**
- The theorem states that international trade tends to equalize the factor prices between the trading nations.
- In absence of foreign trade, it is quite likely that factor prices are different in different countries.

INTERNATIONAL PRODUCT LIFE CYCLE (VERNON)

- The product life-cycle theory was developed by Raymond Vernon in response to the failure of the Heckscher-Ohlin theory to explain the observed pattern of international trade.
- The theory suggests that early in a product's life-cycle all the parts and labour associated with that product come from the area in which it was invented.
- After the product becomes adopted and used in world markets production gradually moves away from the point of origin.
- In some situations, the product becomes an item that is imported by its original country of invention.
- A commonly used example of this is the invention, growth and production of the computer with respect to U.S.A.
- The model demonstrates dynamic comparative cost advantage.
- The country that has the comparative advantage in the production of the product changes from the innovating (developed) country to the developing countries.

INTERNATIONAL PRODUCT LIFE-CYCLE (VERNON)

- Stage -1: Introduction
- New products are introduced to meet local needs, and new products are first exported to countries with similar needs, preference and incomes.
- Stage -2: Growth
- A copy product is produced elsewhere and introduced in the home country to capture growth in the home market. This moves production to other countries, usually on the basis of cost of production.
- Stage -3: Maturity
- The industry contracts and concentrates-the lowest cost producer wins here.
- Stage -4: Saturation
- This is period of stability. The sales of the product reach the peak and there is further no possibility to increase it. Marketing ideas need to be developed and alternative approach to be introduced.
- Stage -5: Decline
- Poor countries are the buyers/markets for these finished/ imported products.