BBA IV Semester

Subject- International Trade

TOPIC- International Trade

BY- Richa Srivastava (HOD)

Department of Business Administration
KAPG college,
Prayagraj.

INTERNATIONAL TRADE

DEFINITION OF INTERNATIONAL TRADE-

C. F. Stanlake - "International Trade is an exchange of goods and services across national boundaries".
Harrold "International Trade appears when the division of labour is pushed beyond national frontiers."
P.T. Ellsworth "International Trade is trade that crosses national boundaries"
Encyclopedia Britannica "International Trade may be defined simply as the exchange of goods and services among nations.

SIMILARITIES IN INTERNATIONAL TRADE AND INTERNAL TRADE

1. Objectives of the Trade - All trade activities are guided by the profit motive.
2. Voluntary Transactions - In both types of trade, they undertake, voluntary and free transactions.
3. Transactions of Goods- In both trade parities undertake the transaction of necessary goods which they require.
4. Two Parties - Buyer (importer) and seller (exporter) in both types of trade.
5. Similarity in nature - The basis of trade in both the cases is division of labour and specialization due to which there will be difference in production price.
6. Optional Bargain - Trade is always voluntary and optional prices.
7. Sales and Marketing Efforts - in all types of trade activities in order to have success and to attract more and more customers.
8. Common commercial Services - In all trades, common commercial services in the form of banking, insurance, communication, transportation and godown etc. are common.
9. Development of cultural and Social Relations - As the trade between different regions develops, the social and cultural relations.
10. Application of comparative cost advantages theory - In both trades.
11. Advantages to Both Parties - In both trades, both trading parties get benefit of trade.
12. Similarity in Operations - In both trades, the basic activities and operation are same.
13. Division or Labour and specialization - Both trades are based on division of labour and Specialization.

DISSIMILARITIES IN INTERNATIONAL TRADE AND INTERNAL TRADE

1. Difference in the mobility of labour and capital
2. Difference in the laws of Returns
3. Different in natural and Geographical conditions
4. Difference in monetary System
5. Difference in international Monetary Institutions
6. Difference in National Policies
7. Difference in Commercial Laws
8. Obstacles to the Import and Export of the Commodities
9. Separation of the Markets
10. Difference related to classes
11. Different Political System
12. Different Business Customs
13. Difference in Objectives
14. Different in Weighs and Measures
15. Difference in distance between buyer and seller
16. Different in Statistical Information
17. Difference in terms of Trade
18. Problems in Payments
19. Existence of trade and Exchange Control
20. Problems of Transportation
21. Different in Competition Level
22. Different Specific Problems
23. Effect on Movement of Capital

THE NECESSITY OF INTERNATIONAL TRADE

1. **ECONOMIC NEED**
    a. To Fulfill the Fundamental Necessities of the Masses
    b. To Import Necessary Technology
    c. For Accelerating the Pace of Economic Development
    d. To Take the Benefits of International Division of Labour and Specialization
    e. For Accumulating Foreign Exchange Reserve
    f. Theory of Opportunity Cost
    g. To Create Infrastructure in the Economy
    h. To take the Comparative Cost Advantages
    i. Difference in Development Level
2. **GEOGRAPHICAL NEED**
    a. Geographical Location and Natural climate
    b. Unequal Distribution of Natural Resources
    c. Natural Calamities
    d. Difference in Hunan Resources
3. **SOCIAL NEED**
    a. Materialistics Attitude
    b. Difference in Culture and Civilization
    c. Desire for Different Tastes and Varied Consumption
4. POLITICAL NEED
    a. Desire to Gain Political Power and Strength
    b. To Cater Imperialistic Interest.
    c. For Political Stability

Theories of International Trade

International trade has become an integral part of each and every economy of the world. It has been in existence since ancient times among nations. It has grown tremendously in modern times. A very pertinent question is this regard is why do nations engage in trade? Why international trade? Why a separate theory is required for international trade? What are the theoretical explanations of the reasons for and pattern of international trade. What are important bases of international trade? A number of international economist and management scholars have attempt to answer these questions and to provide theoretical explanations of the reasons and bases of international trade. A number of theories have been put forward to explain the basis of international trade. A number of theories have been put forward to explain the basis of international trade. On this aspect, there are two views-

A. The classical view and
B. The modern or Ohlin's view

A. THE CLASSICAL VIEW

Absolute Cost Advantage Theory: Adam Smith

This theory of international trade is propounded by Adam Smith (1723-1790) father of Modern Economics. This theory is also known as free trade theory as it assumes no restriction on international trade by any country. According to this theory, the basis of international trade is absolute cost advantages. The trade between two countries will be commodity at an absolute advantage over the other country and other country produce another commodity in the same manner at an absolute advantage over the first country, then both countries would gain by in trade.

The classical economies considered the principle of division of labors as the basis of international trade.

Adam smith was the first economist who sowed the seeds of classical theory of international trade. He was a staunch advocate of free trade and a critic of protectionism. He argues that the application of the principle of division of labours to international trade is advantageous to all nations because it causes each country to specialize in those goods which it is best suited to produce most cheaply. He held that free trade between countries brings about an optimum allocation of productive resources of the world, leading to a enhancement of real income of the trading countries.

In this context, Adam Smith developed the law of absolute cost advantage, for international trade. According to him, trade occurs between two countries if one of them has an absolute advantage in producing one commodity and the other country having absolute advantage in producing some other commodity. In other words, each country specializes in the production of that commodity in which it; enjoys an absolute cost advantage and trades with other countries would result in; optimum allocation of the resources in the world and hence productivity will boost.

This can be illustrated with the help of an illustration. Suppose there are two countries, A and B and each of them can produce say two commodities wine and cloth. As per the assumptions of the classical; economists, all costs are measured only in terms of labour.

If in country A, one unit of the labors per day can produce 25 barrels of wine or 10 bales of cloth. In country b, the same amount can produce 10 barrels of wine or 15 bales of cloth.
The cost conditions in country A and B are given below –

Commodity	**Production of one unit of labour per day**	
	Country A	**Country B**
Wine	25 barrels	10 barrels
Cloth	10 bales	15 bales

A has an Evidently country A has an absolute cost advantage over country B in the production of wine (for 25 barrels are more than 10 barrels), while country B has an absolute advantage over country A in the production of Cloth (for 15 bales, are more than 10 bales).

Thus, country A will specialize in the production of wine in which it has an absolute cost advantage over country B and country B will specialize in producing cloth in which it has an absolute advantage over country A.

The trade between the two countries then will benefit both of them. As it is can be seen that with 2 units of labors, country A will now produce 50 barrels of wine and country B 30 bates of cloth as a result of specialization and international trade. In the absence of international trade, there will be only 35 barrels of wine and 25 bales of cloth produced by cloth produced by both the countries with their

Comparative Cost Advantage Theory : David Ricardo (1817)
The renowned classical economist David Ricardo agreed with the analysis of Adam Smith that international trade would be mutually beneficial if one country has absolute advantage over another in one line of production and another country in other. But Ricardo went flintier and showed that the countries can very well gain by trading even if one of the countries is having an absolute advantage in both the goods over another, provided the extent of absolute advantage is different in the two commodities in question or the comparative advantage is greater in respect of one goods than in that of other. In other words there are comparative differences in cost. To illustrate the comparative cost advantage, Ricardo has taken the hypothetical example of production costs of wheat and cloth in England and Portugal.

Comparative Cost Advantage

Country	**No of Units of Labour Per Unit of wine**	**No of Units of Labour Per Unit of Cloth**
Portugal	80	90
England	120	100

"Each country will specialize in the production of those commodities in which it has greater comparative advantages or least comparative disadvantage.”

A country will export those goods in which the comparative advantage is the maximum and it would import those goods in which its comparative disadvantage is minimum.
In fact, the doctrine of comparative costs was developed, by Ricardo out of his (classical) labours theory of value. According to this theory, the value of any commodity is determined by the labours costs. It asserts that goods are exchanged against one another according to the relative amount of labours embodied in them. The labours cost principle is however, based on the following assumptions –

Assumptions – This classical theory of international trade is based on following assumptions -

1. There are two countries.
2. There are two commodities
3. There is only one factor of production i.e. Labour.
4. Labour theory of price determination is applicable
5. Labour is homogeneous
6. Labour is perfectly mobile and dynamic within the country but static and immobile between countries.
7. The cost ratio between the two commodities is assumed to be constant since production is considered to be subject to the law of constant returns.
8. Tastes in demand and technical level and resource in supply remain unchanged.
9. There is perfect competition in both the markets.
10. There is full employment
11. There is no transportation cost.
12. There is Free Trade or there are no restrictions, barriers and hurdles in international trade.
13. There is barter economy.
14. Both countries are at equal development levels.

According to the principle of comparative costs, under free trade conditions, a country specializes in the production of a commodity in which its comparative advantage is greater or its comparative disadvantage is lesser. Each country exports a commodity in the production of which it has a greater comparative advantage or a lesser comparative disadvantage.

Suppose that there are two countries Portugal and England and that each of them can produce wine and cloth. The relative cost conditions of both these countries are given in the table below:

From the above example, we can calculate the domestic ratio of exchange between the two goods Portugal and England.

Domestic ratio or exchange in Portugal:
1 unit of wine = 0.88 units of cloth.(80/90)
1 unit of cloth = 1.13 units of wine. (90/80)

Domestic ratio of exchange in England:
1 unit of wine = 1.2 units of cloth. (120/100)
1 unit of cloth = 0.83 units of wine. (100/120)
Now let us note the comparative cost ratio of wine and cloth in the two countries.

Comparative cost ratio in Portugal:
For wine (80/120) = 0.66.
For cloth (90/100) = 0.90.

Comparative, cost ratio in England:
For wine (120/80) = 1.50.
For cloth (100/90) = 1.11.

It can be seen from the above analysis that Portugal has comparative cost advantage in production of both wine and cloth. This is because the labours cost for producing 1 unit of wine in Portugal is only 66% of the labours cost require to produce 1 unit of wine in England. Similarly Portugal incurs only 90% of the labours cost incurred by England in the production of 1 unit of cloth.

On the other hand England incurs 150% and111% of the labours cost incurred by Portugal on the production of 1 unit of wine and cloth respectively. Thus, England has a comparative disadvantage in the production of both the commodities

According to Ricardo, trade would still take place between Portugal and England because Portugal has greater comparative cost advantage (67%) in the production of wine 'while England has comparatively a lesser cost disadvantage (111%) in the production of cloth. Thus, Portugal will specialize in the production of wine and England would specialize in the production of cloth.

Gains from International Trade

The gain from trade for each country would depend upon the rate of exchange or terms of trade. As a result of specialization by Portugal in wine due to its greater comparative cost advantage and specialization by England in cloth due to its lesser comparative cost disadvantage there will be an increase in the output of both the commodities. Hence the trade between them will be beneficial to both of them gain from trade.

In no Trade situation, if each of them produces one unit of wine and one unit of cloth Portugal will use 80 + 90 = 170 hours of labors and England will use 120 + 100 = 220 hours of labours. So to produce 2 units of wine and 2 units of cloth, both the countries taken together would use 390 hours of labours (i.e., 170 + 220 = 390) However even the after specialization Portugal will devote 170 hours of labours to produce wine only and England will devote 220 hours of labours to produce cloth only. Hence the output of wine in Portugal would be 2.125 units: and the output of cloth in England would be units. Hence the same amount of labours produces a larger amount of both the commodities after specialization.

Under the international trade, the exchange of commodities depends upon the domestic rates of exchange, namely, 1 unit of wine = 0.89 units of cloth in Portugal for 0.89 (80/90) and I unit of wine = 1.20 units of cloth in England for 1.20 (120/100).

When Portugal and England trade with each other, the actual rate of exchange or the terms of trade will lie between 0.89 and 1.20 units of English cloth for one unit of Portuguese wine. When the international trade takes place, Portugal gains, if by exporting one unit of wine it nets more than 0.89 units of cloth from England. England gains, if by exporting less than 1.2 units of cloth it gets one unit of wine from Portugal.

If, for instance, as Ricardo said, the rate of exchat.ge fixed is unit of wine for one unit of cloth, Portugal benefits because it gets one unit of cloth Portugal benefits because it gets one unit of cloth at a labours cost of 8O hours of labours which would have cost 90 hours of labours if it had produced it at home. Hence Portugal saves 10 hours of labours. It also means that Portugal gets 0.11 units of extra cloth from England for one unit of wine exported. England benefits because it gets one unit of wine for 100 hours of labours ambodied in one unit of cloth. If England had produced one unit of wine at home, it would have cost it 120 hours of labours. It also means that England gets 0.17 units of more wine to every unit of cloth exported.

Thus, this theory shows how countries tend to gain under the condition of free trade when there is international division of labours and specialization based upon the comparative cost advantage. As a, result, the world output of goods produced with a given amount of resources will be larger than without international specialization.

In this example, Portugal produces both commodities at low cost in comparison to England, so there will be no trade because of lack of absolute advantage, but comparatively production of wheat is at low cost and has comparative advantage over England (80/170 < 90/100) or she has 67% low cost and cloth 111% (100/90) high. If in England cost of cloth is 135 instead of 100 then there be no comparative advantage to any country and hence three will be no trade possible.

Thus; the theory of comparatively cost in international trade is applied and each country tends to produce not necessarily what it can produce more cheaply than another country but those commodities which it can produce at the greatest relatives advantage or at the lowest comparative costs.

Critical Evolution of the Theory:

1. It Depends on labour Theory
2. Unrealistic Assumption of Constant Cost
3. Some Static Assumptions:- Many static assumptions like fixed tastes, identical production functions between trading countries and fixed supplied of land labour and capital etc.
4. No Transport Cost Assumption
5. Assumption of Perfect Mobility Inside and Immobile Outside-
6. Not Applicable for more than two countries
7. Assumption of Full Employment
8. Assumption of Perfect Competition.
9. One Sided theory
10. Not Practicable in Defence and strategic Areas
11. Complete Specialization Not Possible
12. No Free Trade
13. In Complete, Artificial and Impracticable for Developing Nations-

The Modern Theory of Factor Endowments or the Heckseher – Ohlin Theory

Introduction

Benin Ohlin formulated the General Equilibrium or Factor Endowment or Factor Proportions Theory of International Trade. It is also known as the Modern Theory of International Trade or the Heckscher-Ohlin (H.O.,) Theory. In fact, it was Eli Heckscher, Ohlin's teacher, who first propounded the idea in 1919 that trade results from differences in factor endowments in different countries, and Ohlin carried it forward to build the modern theory of international trade.

Theory The H.O. theory states that main determinant of the pattern of production, specialization and trade among the regions availability of factor endowments and factor prices. Regions or countries have factor endowments and factor prices. "Some countries have much capital, other have much labour. The theory now says that countries that are rich in capital will export capital-intensive goods. To Ohlin, the immediate cause of international trade always is that some commodities can be bought more cheaply from other regions,, whereas in the same region their production is possible at high prices. Thus the main cause of trade between regions is the difference in prices of commodities based on relative factor endowments and factor prices.

This theory is also known as the "Factor Proportion Analyse" and the "General Equilibrium Theory". This theory was developed by two Swedish economists Eli Heckscher (1920) and his students Berlil Ohlin (1933).

The modern theory is an extensional general equilibrium theory of value. According to this theory, there are no fundamental differences but only quantitative differences between inter-regional trade and international trade. According to Ohlin

"International trade is but a special case of inter-local or inter-regional trade". Hence there is no need to have a separate theory of international trade. The immediate cause or international trade is the difference in commodity price which is due to the difference in the factor supplies in the two countries. A country produces and exports that commodity which uses more intensively the country's relatively abundant factor for production. These differences in factor supplies arise due to disparities in natural endowment and factor endowments. These resources bestowed upon a country by nature. Natural endowment include climate, whether water, rainfall, natures of soil, forest wealth and minerals. Factors endowment refers to the relative amounts of factors of production a country has i.e. land Labour and capital. A country may have more capital and less of labour and vice versa. A country may use factor of production in different combinations or proportions. This is called factor proportions or factor intensely.

A county will export that commodity which it can produce by using its abundant factor more intensely and import that commodity which it cannot produce using scarce factors intensely. On this reasoning, the differences in comparative costs or advantages can be attributed to differences in factor endowment.

Its Assumptions

Before analyzing the theory in detail, we discuss below its assumptions –

1. It is a two-by-two two countries (A and B), two commodities (X and Y), and two factors of production (capital and labour)
2. There is perfect competition in commodity as well as factor markets.
3. There is full employment of resources.
4. There are quantitative differences in factor endowments in different regions, but qualitatively they are homogeneous.
5. The production functions of the two commodities have different factor intensities, i.e. labour-intensive and capital-intensive.
6. Factor intensities are non-reversible.
7. There is perfect mobility of factors within each region but internationally they are immobile.
8. There are no transport costs.
9. There is free and unrestricted trade between the two countries.
10. There is constant return to scale in the production of each commodity in each region.
11. Tastes and preferences of consumers and their demand patterns are identical in both countries.
12. There is no change in technological knowledge.
13. There is incomplete specialization. Neither country specializes in the production of one commodity.

Its Explanation

Give these assumptions, Heckscher and Ohlin contend that the immediate cause of international trade is the difference in relative commodity price caused of differences in relative demand and supply of factor (factor prices) as a result of differences in factor endowment between the two countries. Fundamentally, the relative scarcity of factor-the shortage of supply in relation to demand is essential for trade between two regions. Commodities which use large quantities of scarce factors are imported because their prices are high while those using abundant factors are exported because their prices are low. The H.O. theorem is explained in terms of two definitions-

1. Factors abundance (or scarcity) in terms of the price criterion;
2. Factor abundance (or scarcity) in terms of the physical criterion

We discuss these on by one below –

1. Factor Abundance in terms of Factor Prices - Heckscher – Ohlin explain richness in factor endowment in terms of factor prices. According to their definition, country A is abundant in capital if $(Pc/Pl)A<(Pc/Pl)B$, where Pc and Pl refer to prices of capital and labour, and the subscripts A and B denotes the two countries. In other countries. In other words, if capital relatively cheap in country A, the country is abundant in capital, and if labour is relatively cheap in country B, the country is abundant in labour. Thus country A will produce and export the capital-intensive good and import the capital intensive good.

   This establishes the H.O. theorem that the capital abundant country will export he relatively cheap capital intensive commodity, and the labour abundant country will export the relatively cheap labour intensive commodity.
2. Factor Abundance in Physical Terms – Another way to explain the H.O. theorem is in physical terms of factor abundance. According to this criterion, a country is relatively capital abundant if it is endowed with a higher proportion of capital and labour, than measured in physical amounts $Ca/La> Cb/Lb$, where Ca and La are the total mounts of capital and labour respectively in country B.

   The H.O. theorem is physical criterion will be valid only if tastes (demand or consumption preferences) for each commodity in the two countries are identical.

Its superiority over the classical theory of international trade in many aspects

1. **International Trade A special Case –** The H.O. theory us superior to the classical theory in that it regards international trade as a special case of interregional or inter local trade as distinct from the classical theory which considers international trade totally different from domestic trade.
2. **General Equilibrium theory –** The H.O. analysis is cast within the framework of the realistic general equilibrium theory of values. It frees the classical theory from the defunct and unrealities labour theory of value.
3. **Two factors of Productions** – the H.O. model takes two factors-labour and capital as against the one factor (labour) of the classical model, and is thus superior to the latter.
4. **Differences in Factors Supplies** – The H.O. theory is superior to the Rlcardian theory in that it regards differences in factors suppliers as basic for determining the pattern of international trade while the Ricardian theory takes no notices of it.
5. **Relative Prices of Factor –** The H.O. model is realistic because it is based on the relative price of goods, while the Ricardian theory consider the relative prices of good only.
6. **Relative Productivities of Factors –** H.O. theory consider differences in relative productivities of labour and capital as the basis of international trade, while the classical theory takes the productivity of labour alone. Hence the former is more realistic than the letter.
7. **Differences in Factor Endowments –** The H.O. model is based on differences in factor endowments in different countries as against the quality of one factor labour in the classical theory. Thus the former is Superior because it lays emphasis not only on the quality but also on the quantity of factors in determining international values.
8. **Causes of Differences in Comparative Costs –** According to Samuelson, the Ricardian theory could not explain the causes of difference in comparative advantage. The merit of H.O. theory lies in explaining the same satisfactorily.
9. **Positive Theory –** The classical theory demonstrates the gains from trade between the two countries. This is related to the welfare theory. On the other hand, the H.O. model is scientific and concentrates on the basis of trade. It, thus partakes of the positive theory.
10. **Location Theory –** According to Haberler, the H.O. theory is a location theory which highlights the importance of the space factor in international trade while classical theory regards the different countries as space less markets. Thus the former theory is superior to the latter.
11. **Production function of two countries –** The H.O., theorem is explicitly based on the assumption of production functions of the two countries. On the other hand, the classical theory is based on difference in the production of the trading countries.
12. **Complete specialization –** The H.O. model realistic than classical theory in that the former leads to complete specialization in the production of one commodity by one country and of the other commodity by the second country when they enter into trade with each other. By contrast, the trade between countries may not lead to incomplete specialization in the classical theory.
13. **Future of Trade –** According to Lancaster, the H.O. theory is superior to the classical theory because it refers to the future of trade. In the classical theory, difference in comparative costs between two countries is due to difference in the efficiency of labour. If, in future, labour becomes equally efficient in both the countries, there will be no trade between them. But in the H.O. theory trade will not cease even if labour becomes equally efficient in the two countries because the basic of trade in factor endowments and process.

Critical Evaluation of Modern Theory –

1. It takes into consideration all the cost not only the labour cost and not only the labour cost as in classical theory.
2. This theory introduced the economics of large scale production and claimed that these economies created an additional basis for international trade.
3. The classical economists felt the need of a separate and distinct theory of international trade while Ohlin was of the opinion that there was no need of a separate theory. The difference between the two was one of the degrees not of kind.
4. Modern theory of emphasis the differences in factor endowments.

5. The classical theory does not explain why there are differences in comparative cost but modern theory is able to do so.
6. The classical theory is unrealistic where as modern theory is realistic.

Short Comings or Criticism of Modern Theory:

1. It is Based on wrong and Over Simplified Assumptions So It is Unrealistic
2. It Only Provides a Partial Equilibrium.
3. It fails to Explain Leontief Paradox
4. Highly Static in Nature
5. Commodity Prices Determine Factors Prices
6. Trade with Identical Factor
7. Trade Possible in differential products.
8. Production Function not identical
9. No International: Immobility of Factors
10. Homogeneity of the Productive Factors
11. It Ignores Factor Reversal