

# Theories of International Trade

Class 4

# Theories of International Trade

<b>Classical Country-Based Theories</b>	<b>Modern Firm-Based Theories</b>
<p>Mercantilism</p> <p>Absolute Advantage</p> <p>Comparative Advantage</p> <p>Heckscher-Ohlin</p>	<p>Country Similarity</p> <p>Product Life Cycle</p> <p>Global strategic Rivalry</p> <p>Porter's National Competitive Advantage</p>

**Merchantalism** - Developed in the 16th century- it was one of the earliest effort to develop an economic theory

- This theory stated that a country's wealth was determined by the amount of its gold and silver holdings.
- >> so a country should increase its holdings of gold and silver by promoting exports and discouraging imports.
- This will happen when people of other countries buy more from you (exports) than they sell to you (imports)

# The **three principles** on which mercantilism is based are :

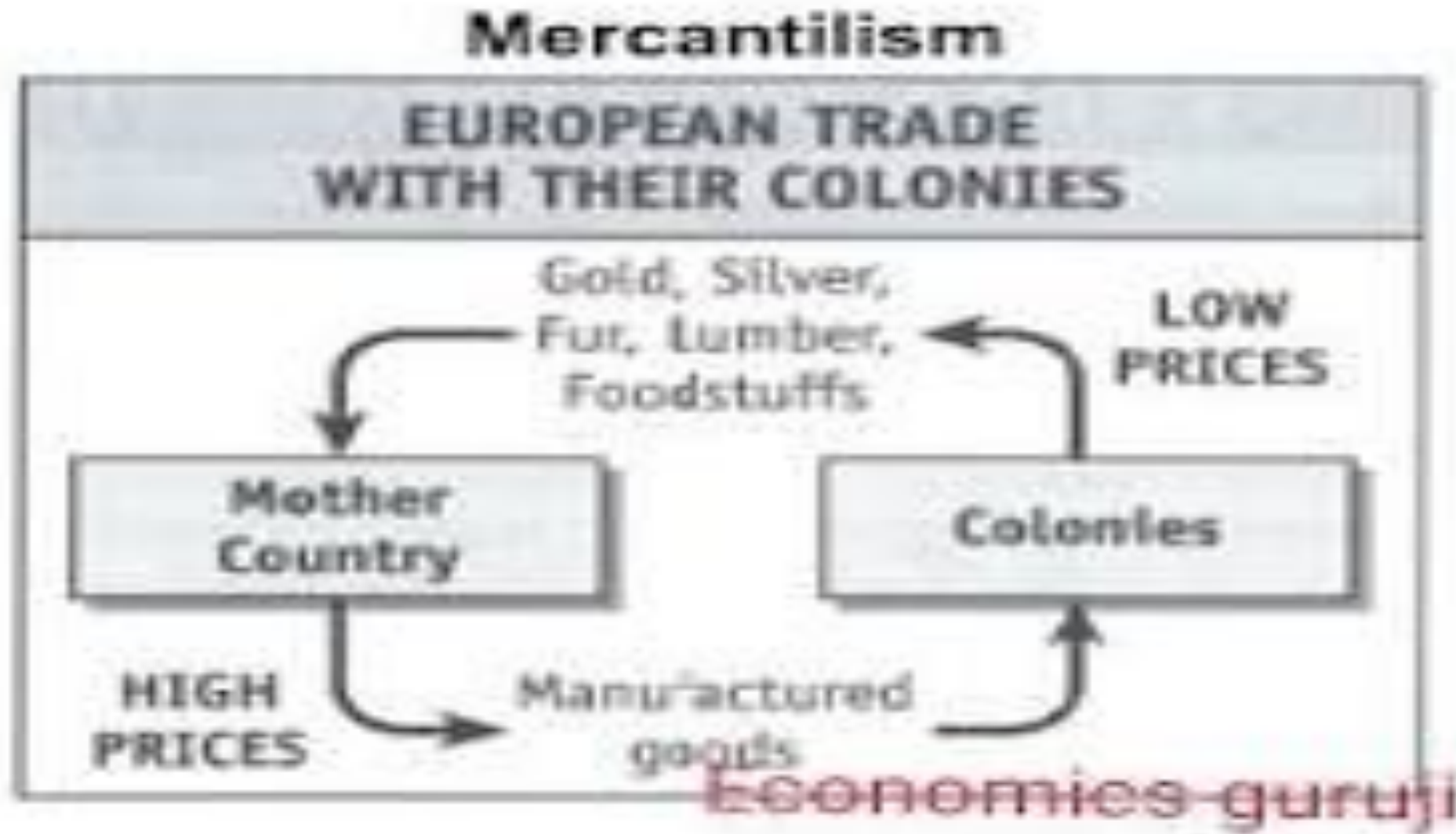
- the amount of wealth in the world is relatively static
- a country's wealth is best measured by the amount of precious metals it possesses
- exports are to be encouraged and imports to be reduced to obtain a favourable balance of trade in order to yield precious metals (Gold and silver).

The objective of each country should be to have

a **trade surplus**, i.e.,  
value of Exports > value  
of imports and

to avoid a **trade deficit**, i.e., a situation  
where the value of  
imports > the value of  
exports.

## Effect of Mercantalism:



# Mechanism of Mercantalism:

## How Mercantilism Works?



It only created Colonies and lead to exploitation:





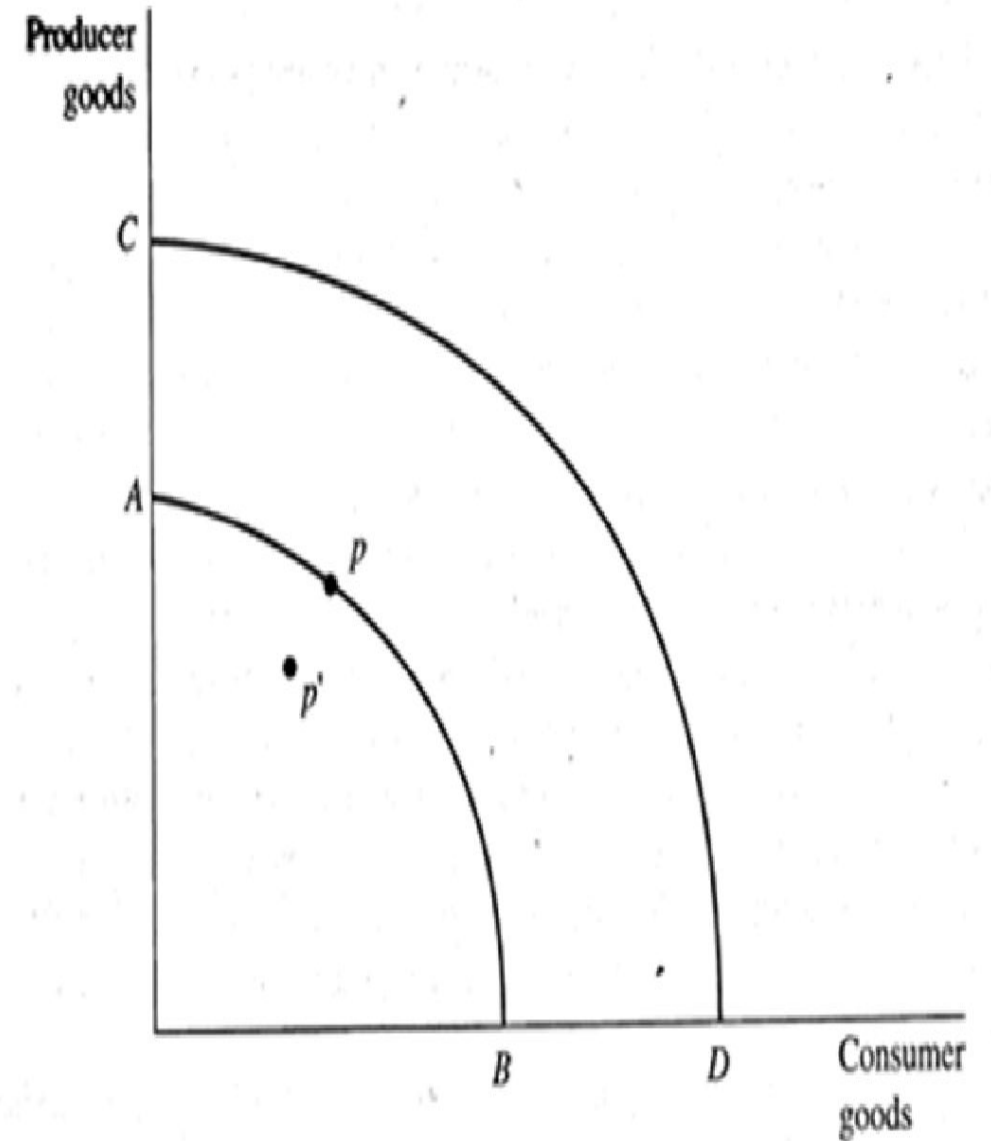
## Thus, Features of Mercantalism stream of International Trade summary >>

- Countries should strive to have trade surplus always.
- Trade surplus will bring in gold and silver
- Created Colonies
- Lead to exploitation of already the less developed by the advanced economies
- Imports of raw materials at low prices and export of finished goods at high prices
- Broadened Inequalities



# Lets first know about PPC (Production Possibility Curves?)

- Now, Answer the following question.
- What is a Production Possibility Curve ?  
Explain with a diagram



# CLASSICAL THEORIES OF INTERNATIONAL TRADE

- The Classical thoughts succeeded the Merchantalism line of thoughts.
- >>> According to them International Trade is very important but under some restricted assumptions.
- >>> They mainly focussed on issues like:
  - i. Under what conditions trade will be beneficial for the participating countries
  - ii. The direction of foreign trade , i.e., who should import and export what.
- By Adam Smith and Ricardo

# ASSUMPTIONS OF :-

- THE CLASSICAL THEORY OF INTERNATIONAL TRADE

# Adam Smith's Absolute Advantage Theory - 1776

- He questioned the leading mercantile theory of the time in his famous book >>
- An Inquiry into the Nature and Causes of the Wealth of Nations also called 'The Wealth of Nations'.

# Pioneer of LAISSEZ-FAIRE ECONOMY

- He advocated a new trade theory called The Absolute Advantage Theory, which focused on the ability of a country to produce a good more efficiently than another nation.
- He advocated for free trade between countries without any regulations or restrictions by government policy or intervention.
- Trade should be determined through the free flow of market forces, which he termed the 'Invisible Hand'.

Assuming a hypothetical 2 country world- The Absolute Advantage Theory states that>>

- >> if Country A could produce a good cheaper or faster (or both) than Country B, then Country A has the absolute advantage in the production of that product and so it should specialise in the production of that good. Similarly, if Country B is better at producing another good, it should specialise in the production of that good.

How to know where the country is efficient ? We have to understand *the cost differences in production.*

# Lets understand Cost Differences:

- Equal Cost Differences
- Absolute Cost Differences
- Comparative Cost Differences



# Equal Cost Differences

- Hours of Labour necessary to produce one unit of Wheat and Cloth

	Wheat	Cloth	Domestic Barter Rate
India	40a <sub>1</sub>	80b <sub>1</sub>	?????
England	60a <sub>2</sub>	120b <sub>2</sub>	?????

Cost ratios can be measured as :

a<sub>1</sub>/b<sub>1</sub> and  
a<sub>2</sub>/b<sub>2</sub> **OR**  
a<sub>1</sub>/a<sub>2</sub> and  
b<sub>1</sub>/b<sub>2</sub>

# Absolute Cost Difference

## Hours of Labour necessary to produce one unit of Wheat and Cloth

	Wheat	Cloth	Domestic Barter Rate
India	40a1	80b1	?????
England	80a2	40b2	?????

Lets see another way to look at absolute adv.

Country	India	China
	(Output per unit of labour)	
Wheat	20	8
Cloth	6	14

Draw its straight line PPC ?  
Which country has absolute Adv in which product ?

## NOW LETS SOLVE THE ABOVE QUESTION OF ABSOLUTE ADVANTAGE

- What should India and China Specialise in ?
- That is, what should be the direction of trade \_ which country will export what and import what ?

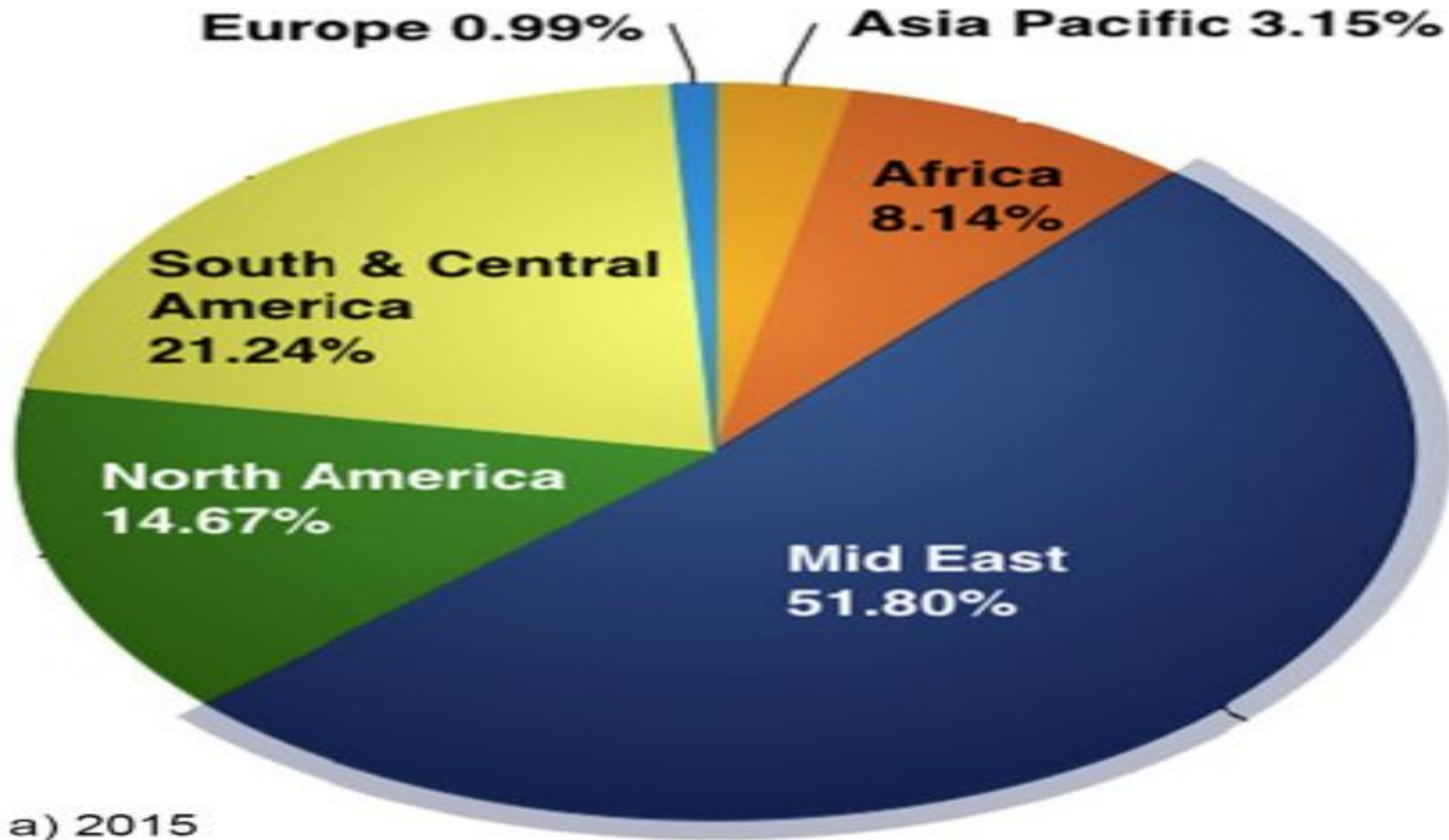
Why so?? Because >>>>

- >> Specialization would make the countries efficient in the production of that product/s as their labor force would have to do the same tasks increasing their skill in it.

## Examples of Absolute advantage:

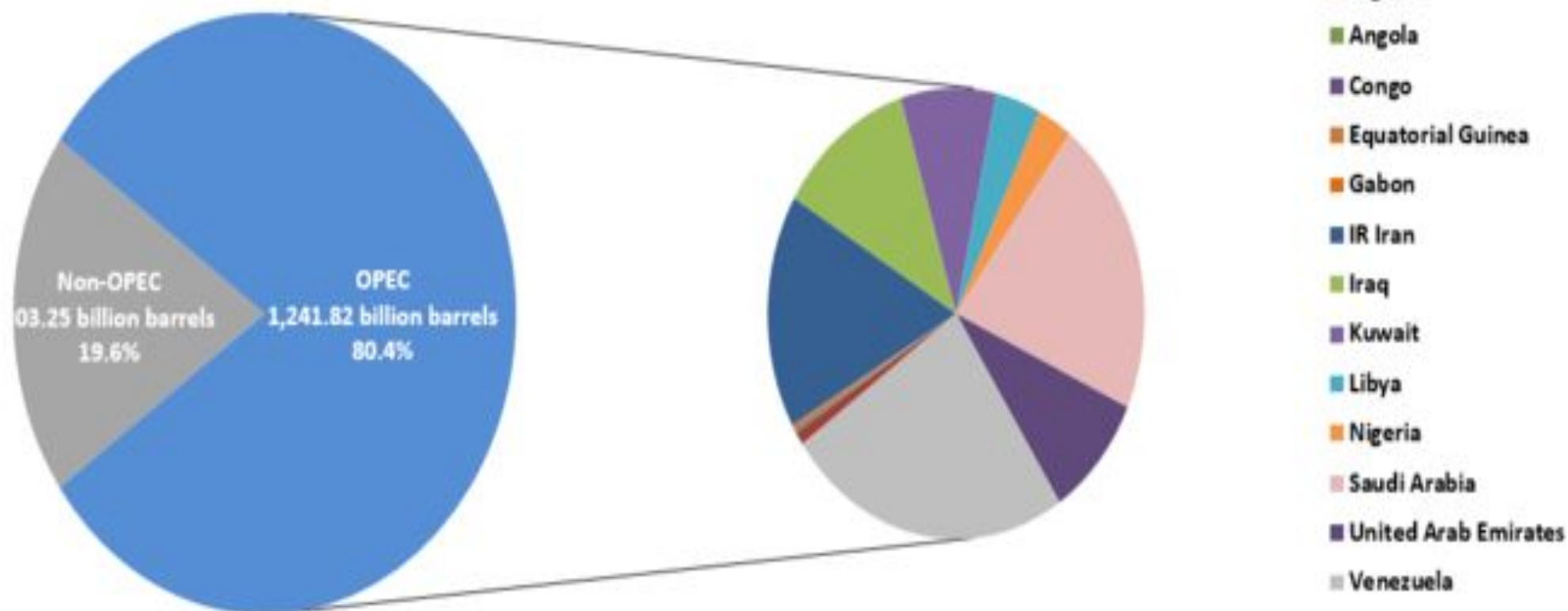
- **Definition: Absolute Advantage:** Refers to the ability of a person, firm or nation to produce more of a product with same amount of resources or same quantity of a product with fewer amount of resources.
- **Difference from Merchantalism:** This theory stated that a nation's wealth shouldn't be judged by how much gold and silver it has but rather by the living standards of its people.
- **Can you cite some Real world examples of Absolute advantage Theory?**

# Oil producing nations in the middle east.





# OPEC share of world Crude Oil Reserves, 2021

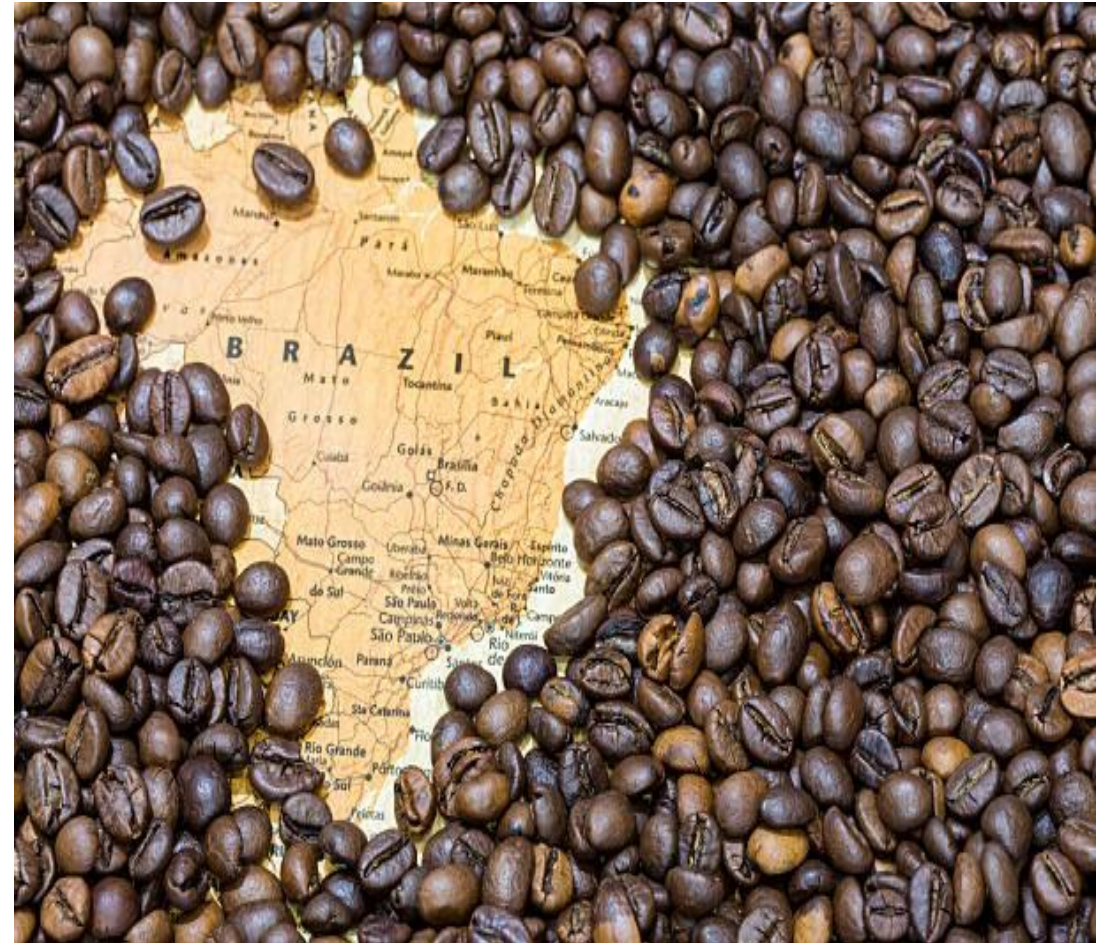


## OPEC proven crude oil reserves , at end 2021 (billion barrels, OPEC share)

Venezuela	303.47	24.4%	United Arab Emirates	111.00	8.9%	Algeria	12.20	1.0%	Equatorial Guinea	1.10	0.1%
Saudi Arabia	267.19	21.5%	Kuwait	101.50	8.2%	Angola	2.52	0.2%			
IR Iran	208.60	16.8%	Libya	48.36	3.9%	Gabon	2.00	0.2%			
Iraq	145.02	11.7%	Nigeria	37.05	3.0%	Congo	1.81	0.1%			



# Coffee production in South American nations.





# Italy's wine production.



# Copper reserves of Chile and Zambia.



- According to The World Copper Factbook 2022, released by The International Copper Study Group (ICSG), Chile emerged as a preeminent figure in 2021, responsible for a substantial fraction of the world's copper output.

# Answer the following:

•Q1(i) What is meant by Production Possibility curve(PPC) of a nation?

•(ii) What are the possible shapes of the PPC ? Write about the implications of these shapes?

# What is an Opportunity Cost?

- To understand the theory behind, it is crucial to understand the idea of an opportunity cost.
- An opportunity cost is the foregone benefits from choosing one alternative over others. Thus, it is the cost of the next best alternative that is given up to obtain the good.

Thus, the formula for opportunity cost is:

$$\text{Opportunity cost of Good A} = \frac{\text{Quantity of good B}}{\text{Quantity of Good A}}$$



# Examples to explain opportunity cost of Production

- A farmer chooses to plant wheat; the opportunity cost is planting a different crop, or an alternate use of the resources (land and farm equipment)

For example, a laborer can use one hour of work to produce either 1 cloth or 3 wines.

So>> What is the forgone benefit(opportunity cost) from choosing to produce one cloth or one wine?

Therefore:

By producing one cloth, the opportunity cost is 3 wines.

By producing one wine, the opportunity cost is  $\frac{1}{3}$  cloth.



# Comparative Advantage Theory

- What if, a country that has an absolute advantage in producing all goods? So will trade not be beneficial in this case?
- The theory of Comparative Advantage states that trade will still be beneficial as the basis of the gains for trade is comparative advantage, not absolute advantage.
- So let's understand Comparative cost difference.....

**This theory of Comparative Advantage was:**

- >> stated by David Ricardo in 1871
- >> In his book 'Principles of Political Economy and Taxation'.

# According to the Comparative cost Advantage Theory

- >> The theory of comparative advantage shows that even if a country enjoys an absolute advantage in the production of goods, trade can still be beneficial to both trading partners.
- When a country has absolute advantage in the production of both the commodities, it will be beneficial for it to produce and export that commodity in which it has a Comparative Cost Advantage.

# Opportunity Cost

- To know in which product it has comparative advantage, we use the principle of Opportunity cost of production

Remember >>>

Opportunity cost of

Good A =

$$\frac{\text{Quantity of good B}}{\text{Quantity of Good A}}$$

Remember:

- It is not possible for an individual or country to have a comparative advantage in all goods.
- There will be some other individual or country that can produce some things at lower opportunity costs.

# Comparative Cost Difference

## Hours of Labour necessary to produce one unit of Wheat and Cloth

	Wheat	Cloth	Domestic Barter Rate
India	40a1	80b1	?????
England	90a2	100b2	?????

Q1 . Which country has absolute advantage in which product ?

Q2. What is the domestic barter rate of each country?

Q3. Draw the PPC and production possibility lines.

Q4. What should be the direction of trade ?

## Remember>>

- **Comparative cost advantage**

- A country has a comparative cost advantage when it can produce a good at a lower opportunity cost than another country. This means that it has to give up less of other goods to produce it.

- **Opportunity cost**

- The opportunity cost is the potential benefit that is lost when choosing one option over another. It is also known as the alternative cost.



## Result :

- To conclude, a country under comparative cost advantage should produce the good in which it has more comparative advantage(here India) or less comparative disadvantage (here England)

Factors like possession of natural resources, established infrastructure, climate and geographical features etc gives some countries advantages over others.

- A country's production efficiency is measured by taking a look at the opportunity cost they incur by producing the good.
- The country that has a lower opportunity cost is more efficient or better at producing the good than the other.

# Terms of Trade and Gains from Trade in classical theory

- Thus the Absolute and comparative cost theories have shown how to get the limiting ranges between which the actual rate will be determined under trade between the countries.

We will discuss about this further under the Gains From Trade.

Remember:

- A country has an absolute advantage if it can produce more of a good than another country using the same level of resources.
- A country has a comparative advantage when it can produce a good with a lower opportunity cost than another.

# Criticisms of Classical Trade Theory

- 1. Assumptions of only labour cost
- 2. Assumptions of constant costs
- 3. Assumptions of factor mobility
- 4. Assumptions of 2 x2 model
- 5. Neglect of Transport cost
- 6. Growing emphasis of Self-efficiency (like for military goods)
- 7. Impossibility of complete specialisation

# Question 1: Example: Comparative Advantage

- Consider two countries (France and the United States) that use labor as an input to produce two goods:

wine and cloth.

- In France, one hour of a worker's labor can produce either 5 cloths or 10 wines.
- In the US, one hour of a worker's labor can produce either 20 cloths or 20 wines.
- Answer the Following questions:

# Answer the Following questions:

- Q i. Illustrate this information with a table.
- Qii. Which country has an absolute advantage in which commodity? Explain Your answer.
- Qiii. Which country has comparative Advantage in which commodity, in terms of Opportunity Cost of production?
- Qiv. What should be the direction of trade( exports and imports)?
- Qv. Show the production possibility curves of each country, assuming that the maximum amount of labor hours is 100 hours, for each.

**Q. Justify the following statements:**

- i. "Self-sufficiency" is not an acceptable trait in the globalised economy.
- ii. Nations which tries to produce everything for themselves are likely to end up poorer than those that engage in specialization and trade.



# Watch it out:

- [https://www.google.com/search?q=benefits+on+international+trade+videos&rlz=1C1CHBF\\_enIN1014IN1014&oq=benefits+on+international+trade+videos&gs\\_lcrp=EgZjaHJvbWUyBggAEEUYOTIHCAEQIRigATIKCAIQIRgWGB0YHtIBDzExMDg5MjQyODdqMGoxNagCALACAA&sourceid=chrome&ie=UTF-8#fpstate=ive&vld=cid:d36306d0,vid:IFUG307RI4I](https://www.google.com/search?q=benefits+on+international+trade+videos&rlz=1C1CHBF_enIN1014IN1014&oq=benefits+on+international+trade+videos&gs_lcrp=EgZjaHJvbWUyBggAEEUYOTIHCAEQIRigATIKCAIQIRgWGB0YHtIBDzExMDg5MjQyODdqMGoxNagCALACAA&sourceid=chrome&ie=UTF-8#fpstate=ive&vld=cid:d36306d0,vid:IFUG307RI4I)

# THANK YOU

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