HECKSCHER-OHLIN

THEORY OF INTERNATIONAL TRADE

HECKSCHER OHLIN Theory of International Trade

- >> **Also known as the Modern Theory of International Trade**
- >> **It was first formulated by Swedish Economist Heckscher in 1919 and later on developed by his student Ohlin in 1935.**
- According to them , International trade is a special case of inter-local or inter-regional trade. And so there is no need to have a separate theory of International Trade.

According to this theory >>

- >> It is the differences in the Factor endowments and not the differences in their efficiencies(as was the basis of Classical theory), which is the basis of International Trade.
- **So It is also known as the Factor Endowment Theory**
- **>> It explains the pattern of comparative advantage and hence the pattern of trade in terms of factor endowments.**

The theory states that >>

- >> The country has a comparative advantage in the production and export of the good that is **relatively intensive in the country's relatively abundant factor.**
- In other words, the theory predicts that goods requiring greater amount of labour should be produced in countries where labour is abundant relative to other factors of production.
- Here the labour cost will therefore be low relative to the cost of the other factors of production.
- These countries then exports labour intensive goods to other countries where labour is relatively scarce and labour costs are relatively high.

Arguments of Heckscher-Ohlin Theory

- \>> Two countries will enter into trade only when there is a price difference between the commodities.
- \>> Under competitive market conditions, price will be equal to the average cost of production. Thus, the price differences between the commodities will be due to the cost differences in their production.
- \>> Cost Differences exists due to factor price differences between the countries.

Arguments of Heckscher-Ohlin Theory(contd.)

- Factor prices are determined by the demand and supply of the factors.
- Assuming a given demand, a capital rich country will have cheaper capital or low capital prices and vice versa.
- **Each country has comparative advantage in the production of the commodity which uses its abundant factor and exports it.**

The theorem is based on the following assumptions:

- (i) It is a 2x2x2 model
- (ii) There are no transport costs or other impediments to trade;
- (iii) There is perfect competition is both commodity and factor markets;
- (iv) All production functions are homogeneous of the first degree;

assumptions(contd.)

- (v) The production functions are such that the two commodities show different factor intensities;
- (vi) The production functions differ between commodities, but are the same in both countries, that is good (A) is produced with the same technique is both countries and good (B) is produced with the same technique in both countries.

Definition of Relative Factor Abundance:

- **(i) Physical Definition:**
- *A* country is called **capital-abundant** provided the ratio of quantity of capital to quantity of labour in that country is greater than the corresponding factor quantity ratio in the other country irrespective of the fact whether or not the ratio of price of capital to price of labour in that country is less than the corresponding factor price ratio in the other country.

For Example:

- Say, country 1 is said to be capital abundant relative to country 2, if country 1 is endowed with more units of capital per unit of labour relative to 2, that is, if the following inequality holds :
- $qC1/qL1 > qC2/qL2$
- Where $qC1$ is the total amount of capital in country 1,
- $qL1$ is the total amount of labour in country 1,
- and $qC2$ and $qL2$ are the total amount of capital and labour, respectively in country 2.

(ii) Factor Abundance >> Price Definition:

- A country is called capital abundant provided the ratio of price of capital to price of labour in that country is less than the corresponding factor price ratio in the other country irrespective of the fact whether or not the ratio of quantity of capital to quantity of labour in that country is greater than the corresponding factor quantity ratio in the other country.

- Country 1 is said to be capital abundant relative to country 2 if at the pre-trade autarkic equilibrium state capital is relatively cheaper in 1 than In 2. More precisely, 1 is said to be capital abundant relative to 2, if at the pre-trade autarkic equilibrium state, the following inequality holds:

PC1/PL1 < PC2/PL2

- where PC1 is the price of capital in country 1,
- PL1 is the price of labour in country 1, and
- PC2 and PL2 are the prices in country 2 of capital and labour, respectively. In other words, if capital is relatively cheap in country 1, the country is abundant in capital, and
- if labour is relatively cheap in country 2, country 2 is rich in labour. Country 1 will export the capital intensive good and country 2 will export the labour exclusive good.

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