II MA Economics

Unit I

International Economics-I

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Title 1 : International Trade :Meaning

- Internal or interregional trade refers to trade between regions within a country.

- International Trade is trade between two nations or countries

Difference between internal and international trade

- Factor mobility:
- Differences in natural resources:
- Geographical and climatic differences
- Different markets
- Different curerecies
- Problem of balance of Payment
- Different political and economic environment

Title 2 : Adam Smith theory of trade

- Advocated the principles of free trade
- Result of advantages of division of labour and specialization;
- describes trade taking place as a result of countries having absolute advantage in production of particular goods, relative to each other;
- Every country should specialise in the production of that commodity which it can produce more cheaply than others and exchange it for the commodities which cost less in other countries

Absolute differences in cost

Country	Commodity X	Commodity Y
A	10	5
B	5	10

A has an absolute advantages in the production of X and B has an absolute advantage in Y

Gains from Trade

Commodity / Country	Production Before Trade (1)		Production after Trade (2)		Gains from Trade (2-1)	
	X	Y	X	Y	X	Y
A	10	5	20	---	+ 10	-5
B	5	10	---	20	- 5	+10
Total Production	15	15	20	20	+5	+5

Country A specialize in commodity X and use both units of labour total production will be 20 units, similarly for B in commodity Y . the combined gain will be 5 units in each country after the trade.

Title 3: Ricardo theory of Comparative cost

It is not absolute but the comparative differences in cost that determines trade relations between countries

Each country specialises in the production of that commodity in which its has the greatest advantage or the least comparative disadvantages cost of production

A country will export those commodities in which its comparative advantages is the greatest and import those commodities in which its comparative disadvantage is least.

Suppose India produces computers and rice at a high cost while Japan produces both the commodities at a low cost. It does not mean that Japan will specialise in both rice and computers and India will have nothing to export. If Japan can produce rice at a relatively lesser cost than computers, it will decide to specialise in the production and export of computers and India, which has less comparative cost disadvantage in the production of rice than computers will decide to specialise in the production of rice and export it to Japan in exchange of computers.

Explanation of the Theory

Country	Wine	Cloth
England	120	100
Portugal	80	90

England uses more labours than Portugal . so Portugal labour is more efficient and possess an absolute advantage in both wine and cloth

Gains from Trade

England	Portugal
Wine 120 : cloth 100 (6/5) 1 : 1.2	Wine 80 : cloth 90 (8/9) 1: 0.89
Cloth 100 : wine 120 (5/6) 1 : 0.83	Cloth 90 : wine 80 (9/8) 1: 1.13

Domestic exchange ratio in England is one unit of cloth =0.83 and Portugal one unit of wine 0.89. if assume that exchange ratio between the country 1=1 of wine and cloth, England would gain 0.17 (1- 0.83)unit of wine by exporting one unit of cloth to Portugal. Similarly Portugal will gain by exporting one unit of wine to England will be 0.11 (1-0.89) unit of cloth.

criticisms

- Unrealistic assumptions of labour cost
- No similar tastes
- Unrealistic assumptions of constant cost
- Two country two commodity model unrealistic
- Factors not fully mobile internally
- Ignores transport cost

Title : 4 Hecksher- Ohlin theory

- Modern thoery of Factor Endowments

HO theory states that the main determinant of the pattern of production , specialisation and trade among regions is the relative availability of factor endowment and factor prices

Countries that are rich in capital will export labour intensives goods and countries that have much labour will export labour intensive goods

Assumptions

1. 2x2x2 model
2. perfect competition in commodity and factor market.
3. full employment of resources
4. quantitative differences in factor endowments in different regions
5. perfect mobility of factors, no transport cost
6. constant return to scale

The main cause of trade between regions is the difference in relative commodity prices caused by differences in relative demand and supply of factors as a result of differences in factor endowments between the two countries.

Explained by two definitions

1. factor abundance in terms of price criterion.
2. factor abundance in terms of physical criterion

1. Factor abundance in terms of factor price
explain richness in factor endowments in terms of factor prices. If country A is abundant in capital it is relatively cheap in that country and if labour is relatively cheap in country B the country is abundant in labour. Thus country A will produce and export capital intensive goods and import labour intensive goods. Similarly country B will produce and export the labour intensive goods and import capital intensive goods

2. Factor abundance in physical terms

According to this criterion a country is relatively capital abundant if it is endowed with a higher proportion of capital and labour than the other country.

Superiority over classical theory

1. international trade a special case
2. general equlibrium theory
3. two factors of production
4.differences in factor supply
5. relative prices and productivities of factors
6.differences in factor endowments
7. causes of differences in comparative costs
8. complete specialisation
9. future trade

Title 5 : Haberler Opportunity Cost Theory

The opportunity cost theory says 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 Exchange ratio between the two commodities is expressed in terms of their opportunity cost.

- Assumptions
- Two countries, two factors L,K, and two goods X,Y
- Price of the commodity equals its marginal money costs;
- Perfect competition prevails in both markets;
- No change in technology
- Factors immobile between countries but mobile within countries;

- **Explanation of the theory**

Shape of the production possibility curve under different cost conditions that determines the basis and the gains from international trade under the theory of opportunity cost.

- If the amount of X is given up in order to get one additional unit of Y the PP curve is concave and show increasing opportunity cost

- If the amount of Y is given up in order to get one additional unit of X the PP curve is convex and show diminishing opportunity cost

- If the amount of Y is required to be given up to get additional qty X remain constant the PP curve would be straight line and indicate **constant opportunity cost**

Title :6Leontief Paradox

- Attempt to verify the Hecksher Ohlin Model
- HO theory states that capital abundant country will export relatively capital intensive goods and will import relatively large amount scarce factor labour required.
- Leontif study reached the paradoxical conclusion that USA possess relatively large amount of capital and relatively small amount of labour , exported labour-intensive goods and imported capital intensive goods.

- Leontief used 1947 input output table of USA economy.
- Aggregated 200 groups of industries and 50 sector .

- Result showed that US import replacement industries was 30% higher than US export industries . It means that US import labour competing industries are relatively more capital intensive than export industies.

- Criticism

- 1947 not a typical year
- Problem of aggregation
- Low capital labour ratio industries
- Consumption pattern
- Tariff ignored
- Neglect of natural resources
- Labour Productivity
- Neglect of human capital