UNIT 1 CLASSICAL AND NEO-CLASSICAL THEORIES OF INTERNATIONAL TRADE*

Structure

1.0 Objectives
1.1 Introduction
1.2 Theory of Mercantilism
1.3 Absolute Advantage Theory
1.4 Comparative Advantage Theory
1.5 Heckscher–Ohlin Theory
1.6 Stolper – Samuelson Theorem
1.7 Factor-Price Equalization Theorem
1.8 Rybczynski Theorem
1.9 Lets Sum Up
1.10 Key Words
1.11 Some useful References
1.12 Answers/Hints to Check Your Progress Exercise

1.0 OBJECTIVES

After studying this Unit, you should be able to:

- Explain the difference between Domestic and International Trade;
- describe why two nations trade with each other;
- explain Absolute Advantage Theory;
- explain Comparative Advantage Theory;
- differentiate between Absolute Advantage Theory and Comparative Advantage Theory;
- describe Heckscher–Ohlin Theory;
- explain the Stolper – Samuelson theorem;
- explain Factor Price Equalisation theory; and
- describe Rybczynski Theorem.

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1.1 INTRODUCTION

In this unit, we will discuss the major theories of international trade. At the beginning of this unit, we will try to understand what international trade is and how it differs from domestic trade. The reasons why countries trade with each other will also be discussed. Having understood these, the major theories of international trade that have evolved, like absolute advantage theory, comparative theory, and H-O theory, will be explained. Further, the theories like Stolper – Samuelson theorem, Factor Price Equalisation theory, and Rybczynski theorem developed by extending the H-O model will also be discussed.

Before reading the theories of international trade you should understand what is, international trade, and why does trade take place?

In simple words, trade refers to buying and selling goods and services in exchange for money. The sellers sell the goods and services while the buyers buy the same. When these activities occur domestically in the country, it is referred to as domestic trade or only trade. But, when the exchange of goods and services takes place between buyer and seller of two different nations it is called international trade.

Now, the question is, why do we trade at all?

The simple answer to this question is that any nation cannot produce everything it needs. One nation may have plenty of natural resources but a scarcity of meat, fish, etc. One country may be an efficient milk producer but have a scarcity of wheat and rice. In this situation, nations come together and exchange goods among them. We will discuss more about gains from trade in Unit 2.

1.2 THEORY OF MERCANTILISM

Mercantilism is an exercise that is more than 500 years old. The base of this theory was the "commercial revolution", the transition from local economies to national economies, from feudalism to capitalism, and from a rudimentary trade to a larger international trade.

The theory of mercantilism postulates that countries should encourage exports and discourage imports. The tendency to export more and import less and receive gold (as gold was the medium of exchange) in exchange is called Mercantilism. Mercantilism was the economic system of the major trading nations during the 16th to 18th centuries. The theory assumed that national wealth and power were best served by increasing exports and collecting precious metals like gold in return. The theory states that government should play a vital role in regulating the economy to encourage exports and discourage imports by using subsidies and taxes. According to this theory, the government should accumulate as much gold as possible, which can only be done through exports.
1.3 ABSOLUTE ADVANTAGE THEORY

Several theories have been developed in light of the activities discussed above. These theories have evolved for more than 200 years now. Adam Smith propounded the basic theory of international trade in 1776. Adam Smith in his seminal work ‘An inquiry into the Nature and Causes of the Wealth of the Nation’ for the first time, provided a theoretical explanation of why trade should take place between two nations.

Adam Smith, in his book propounded the theory of absolute advantage, which states that a country should specialize in those products which it can produce efficiently, where efficiency is measured in terms of absolute labour costs. This theory assumes that there is only one factor of production: labour.

Adam Smith wrote in ‘The Wealth of Nations’, “If a foreign country can supply us with a commodity cheaper than we can make it, better buy it of them with some part of the produce of our industry, employed in a way in which we have some advantage”.

According to Adam Smith, trade between two nations is based on absolute cost advantage. When one is more efficient than (or has an absolute advantage over) another in the production of one commodity but is less efficient than (or has an absolute disadvantage with respect to) the other nation in producing a second commodity, then both the nations can gain by each specializing in the production of the commodity of its absolute advantage and exchanging part of its output with the other nation for the commodity of its absolute disadvantage. In this process, the resources are utilized most efficiently and the output of both commodities will rise. This increase in output of both the commodities measures the Gains from specialization in production available to be divided between the two nations through trade.
In very simple words, he stated that trade would benefit both countries if country A exported the goods, which it can produce at a lower cost than country B and imported the goods, which country B can produce at a lower cost than it.

The above description of the theory can be understood better with the following example. Suppose there are two countries A and B, which produce wheat and rice with an equal amount of resources i.e. 200 labourers. Country A uses 10 labourers to produce 1 ton of wheat and 20 labourers to produce 1 ton of rice. Country B uses 25 units of labourers to produce 1 ton of wheat and 5 units of labourers to produce 1 ton of rice.

This is evident from Table 1.1 that country A has an absolute advantage in producing wheat as it can produce 1 ton of wheat by using fewer labourers as compared to country B. On the other hand, country B has an absolute advantage in producing rice as it can produce 1 ton of rice by employing fewer labourers in comparison to country A. Now, if there is no trade between these countries and resources (in this case there are a total of 200 labourers) are being used equally to produce wheat and rice, country A would produce 10 tons of wheat (100/10), and 5 tons of rice (100/20) and country B would produce 4 tons of wheat (100/25) and 20 tons of rice (100/5). Thus, total production without trade (i.e., autarky) is 39 tons (14 tons of wheat and 25 tons of rice).

Now, if both countries open up to trade with each other and specialize in goods in which they have an absolute advantage, the total production would be higher. If a trade takes place, Country A would produce 20 tons of wheat with 200 labourers; whereas, country B would produce 40 tons of rice with 200 labourers. Thus, total production would be 60 units (20 tons of wheat and 40 tons of rice).

### Table 1.1 Number of labourers used by Country A and Country B for producing 1 ton of Wheat and Rice

<table>
<thead>
<tr>
<th></th>
<th>Country A</th>
<th>Country B</th>
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</thead>
<tbody>
<tr>
<td>Wheat (1 ton)</td>
<td>10 labourers</td>
<td>25 labourers</td>
</tr>
<tr>
<td>Rice (1 ton)</td>
<td>20 labourers</td>
<td>5 labourers</td>
</tr>
</tbody>
</table>

### Table 1.2 Production volume of wheat and rice without trade

<table>
<thead>
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<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Wheat</td>
<td>10</td>
<td>4</td>
</tr>
<tr>
<td>Rice</td>
<td>5</td>
<td>20</td>
</tr>
</tbody>
</table>

### Table 1.3 Production volume of wheat and rice with trade

<table>
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<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Wheat</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>Rice</td>
<td>0</td>
<td>40</td>
</tr>
</tbody>
</table>
It is clear from the above descriptive example that without specialization, the total production of countries was 39 tons which increased to 60 tons after specialization from trade opportunities. This is the welfare gains from trade. Therefore, the theory of absolute advantages shows that pattern of trade based on absolute cost differences would benefit both the countries.

1.4 COMPARATIVE ADVANTAGE THEORY

Elaborating on the theory of absolute advantage, David Ricardo presented his work in 1817 in his book 'Principles of Political Economy and Taxation'. In this book, he presented the law of comparative advantage. This is one of the most important and still unchallenged laws of economics with many practical applications. The Ricardian theory states that trade can be beneficial for two countries even if one country has an absolute advantage in all the products and the other country has no absolute advantage in any of the products. Ricardo argued that “...a nation, like a person, gains from the trade by exporting the goods or services in which it has its greatest comparative advantage in productivity and importing those in which it has the least comparative advantage”. A nation behaves no differently from an individual who does not attempt to produce all the commodities he needs. Rather, he produces only that commodity that he can produce most efficiently and then exchanges part of his output for the other commodities he needs or wants. The first nation would be better off provided they specialize in the production and export of those commodities in which its absolute disadvantage is smaller (this is the commodity of its comparative advantage) and import the commodity in which its absolute disadvantage is greater (this is the commodity of its comparative disadvantage).

This theory assumes that labour is the only factor of production in two countries, with zero transport cost, and no trade barriers within the countries. This theory can be understood better from the example cited in Table 1.4.

Suppose there are two countries, A and B, producing two commodities, wheat and rice, with labour as the only factor of production. Now assume that both the countries have 200 labourers and use 100 labourers to produce wheat and 100 labourers to produce rice.

Table 1.4 Production of wheat and rice by Country A and B before the trade

<table>
<thead>
<tr>
<th></th>
<th>Country A (in tons)</th>
<th>Country B (in tons)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wheat</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>Rice</td>
<td>40</td>
<td>10</td>
</tr>
</tbody>
</table>

Table 1.4 shows that country A can produce 20 units; whereas, country B can produce 15 units of wheat by employing the same number (100) of labourers. In addition, country A can produce 40 units; whereas country B can produce 10 units of rice by employing 100 labourers.
Theory of International Trade

Thus, country A has an absolute advantage in producing both items. Country A employs the same number of labourers (100 labourers in the production of each item) in producing rice and wheat; however, rice production is higher than wheat production. This reveals that country A has a comparative advantage in producing rice. Similarly, country B also employs the same number of labourers (100 labourers in producing each good) in manufacturing wheat and rice; but, its wheat production is more than rice. It indicates that country B has a comparative advantage in producing wheat.

For example, country A has decided to produce 60 units of rice by employing 150 labourers. It uses 50 labourers to produce 10 units of wheat. On the other hand, country B has decided to use all the 200 labourers to produce 30 units of wheat and stop the production of rice. In this situation, country A exchanges 14 units of rice with 14 units of wheat produced by country B. (see Table 1.5).

### Table 1.5 Production after specialization

<table>
<thead>
<tr>
<th></th>
<th>Country A</th>
<th>Country B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wheat</td>
<td>10</td>
<td>30</td>
</tr>
<tr>
<td>Rice</td>
<td>60</td>
<td>0</td>
</tr>
</tbody>
</table>

### Table 1.6 Situation after the trade takes place

<table>
<thead>
<tr>
<th></th>
<th>Country A</th>
<th>Country B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wheat</td>
<td>24</td>
<td>16</td>
</tr>
<tr>
<td>Rice</td>
<td>46</td>
<td>14</td>
</tr>
</tbody>
</table>

It can be understood from Table 1.6 that both countries have benefitted or gained from trade. Before the trade, country A had only 20 units of wheat and 40 units of rice; after the trade, country A had 24 units of wheat and 46 units of rice.

At the same time, country B has 15 units of wheat and 10 units of rice before the trade, while it has 16 units of wheat and 14 units of rice after the trade. Therefore, comparative advantage theory clarifies that trade can create benefits for both participating countries even if one country has an absolute advantage in the production of both commodities.

Thus, it is clear from the above theories that the mercantilists believed that one nation could gain only at the expense of another nation and advocated strict government control and regulations of all economic activities. Adam Smith believed that all nations would gain from free trade and strongly advocated a policy of laissez-faire (i.e., as little government interference with the economic system as possible). Free trade would cause world resources to be utilized most efficiently and would maximize world welfare. There were to be only a few exceptions to this policy of laissez-faire and free trade. One of these was the protection of industries important for national defence.
Check Your Progress 2

Note: i) Use the space given below for your answers.
   ii) Check your progress with those answers given at the end of the unit.

1) Explain the central proposition of the absolute advantage theory and comparative advantage theory.
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2) Differentiate between Adam Smith and Ricardo’s theory of international trade.
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3) With reference to the Ricardian theory of international trade, explain how nations gain from trade.
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1.5 HECKSCHER-OHLIN THEORY

In the preceding section, we have seen that the difference in relative commodity prices between two nations is the reason for their comparative advantage, which forms the basis for mutually beneficial trade. Then we explained the reason, or cause, for the difference in relative commodity prices and comparative advantage between the two nations. The second way we extend our trade model is to analyze the effect of international trade on the earnings of factors of production in the two trading nations. That is, we want to examine the effect of international trade on the earnings of labour as well as on international differences in earnings. These two important questions were left largely unanswered by Smith, Ricardo, and Mill. According to classical economists, the comparative advantage was based on the difference in the productivity of labour among nations, but they did not explain such a difference in productivity, except for possible differences in climate. The Heckscher–Ohlin theory goes much beyond that by extending the trade model of the previous sections to examine the basis for comparative advantage and the effect that trade has on factor earnings in the two nations. (Salvatore 2013)
Bertil Ohlin has advocated the Modern Theory of international trade. Ohlin has drawn his ideas from Eli Heckscher’s General Equilibrium Analysis. Hence it is also known as Heckscher Ohlin (H-O) Theory.

Heckscher-Ohlin theory begins where the Ricardian theory of international trade ends. The Ricardian theory states that the basis of international trade is the comparative or relative cost differences. But he did not explain how this comparative cost difference emerges. Ohlin’s theory explains the real cause of this difference.

Ohlin states that trade takes place due to the different relative prices of different goods in different countries. The difference in the relative price of a commodity is due to differences in the relative costs and factor prices in different countries.

According to the H-O theory, the differences in factor prices are due to differences in factor endowments in different countries. The trade pattern is explained in terms of differences in relative factor endowments i.e., the relative resource supply in an economy. Ohlin’s theory is also described as the factor endowment theory. Ohlin’s theory is usually expounded in terms of a two-factor model with labour and capital as the two factors of endowments. Trade occurs due to the differences in factor endowments. Some countries have plenty of capital, while others have an abundance of labour. The Heckscher-Ohlin theorem postulates that countries rich in labour will export labour-intensive goods and countries with plenty of capital will export capital-intensive products.

Heckscher-Ohlin’s theory explains the modern approach to international trade based on the following assumptions:

1) There are two countries involved, countries A and B.
2) There are two factors of production, labour and capital.
3) There are two goods, X and Y, of which X is labour-intensive, and Y is capital-intensive.
4) Country A is a labour-abundant country B is capital-rich.
5) There is perfect competition in both the commodity and factor markets.
6) All production functions are homogeneous of the first degree. Hence there are constant returns to the scale.
7) There are no transport costs or other impediments to trade.
8) Demand conditions are identical in both countries.

These assumptions have been made to explain the meaning of comparative price advantage or relative price difference and to deduce the major propositions of the factor endowment theory. Given these assumptions, Ohlin’s thesis contends that, country exports goods which use relatively a greater proportion of its relatively abundant and thus cheap factors. It is implied that trade occurs because differences in relative commodity prices are caused by differences in relative factor prices (thus a comparative advantage) because of differences in the factor endowments among the countries.
The two countries, two commodities & two-factor model, imply that the capital-rich country will export capital-intensive commodities and the labour-rich country will export labour-intensive commodities. But the concept of a country being rich in one factor or the other is not very clear. Economists quite often define factor abundance in terms of factor prices. Ohlin himself has followed this approach. Alternatively, factor abundance can be defined in physical terms. In this case, physical amounts of capital & Labour are to be compared.

**The Price Criterion of Relative Factor Abundance**

According to the price criterion, a country with relatively cheap capital and labour relatively dear is regarded as relatively capital-abundant, irrespective of its ratio of total quantities of capital to labour compared with the other country. In symbolic terms, when:

\[(PK/PL)_E < (PK/PL)_I\]

Country E is relatively capital-abundant. (Here, P stands for factor price and K for capital, L for labour and E and I for the two respective countries.) Ohlin’s theorem may be verified diagrammatically in Figure. 1.1

![Figure 1.1 Diagrammatic explanation of H-O model](image)

Let us take an example of the same two countries viz; England and India where England is a capital-rich country while India is a labour-abundant nation.
In the above diagram, XX is the isoquant (equal product curve) for the commodity X produced in England. YY is the isoquant representing commodity Y produced in India. It is very clear that XX is relatively capital intensive while YY is relatively labour intensive. The factor capital is represented on Y-axis while the factor labour is represented on the horizontal X-axis.

PA is the price line or budget line of the country England. The price line PA is tangent to XX at E. The price line PA is also tangent to YY isoquant at K. Point K will help us to find out how much capital and labour is required to produce one unit of Y in England.

P1B is the price line of the country India, The price line P1B is tangent to YY at I. The price line RS which is drawn parallel to P1B is tangent to XX at M. This will help us to find out how much capital and labour is required to produce one unit of commodity X in India.

Under the given situations, the country England will choose the combination E. This means more specialisation in capital goods. It will not choose the combination K because it is more labour intensive and less capital intensive.

Thus, according to Ohlin, England will specialise in the production of goods X by using the cheap factor capital extensively while India will specialise on commodity Y by using the cheap factor labour available in the country.

Ohlin's theory concludes that the basis of international trade is the difference in commodity prices in the two countries. Differences in commodity prices are due to cost differences resulting from differences in factor endowments in two countries. A capital-rich country specialises in capital-intensive goods & exports them, while a labour-abundant country specialises in labour-intensive goods & exports them.

As the Ricardian framework of comparative advantage was further improved upon in the Heckscher-Ohlin model, similarly, the H-O model was further developed by Paul Samuelson. Hence the extension of the H-O model is also referred to as Heckscher-Ohlin-Samuelson (H-O-S) model. H-O model states that trade takes place due to the different relative prices of different goods in different countries. Heckscher-Ohlin-Samuelson model demonstrates how free movements of goods between countries may bring about the factor price equalization.

There are four main theorems in the H-O-S model.

1) The Heckscher-Ohlin theorem
2) The Stolper-Samuelson theorem
3) The Factor Price Equalization theorem
4) The Rybczynski theorem.
Check Your Progress 3

Note: i) Use the space given below for your answers.
   ii) Check your progress with those answers given at the end of the unit.

1) Point out five major assumptions of the Heckscher-Ohlin theory.

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2) What are the main conceptions of relative factor abundance?

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3) What are the extension theories of Heckscher-Ohlin theory?

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1.6 STOLPER – SAMUELSON THEOREM

Economists Paul Samuelson & Wolfgang Stolper have further contributed to this theory and have developed Stolper – Samuelson theorem. Stolper – Samuelson theorem explains the effect of change in relative product prices on factor allocation and income distribution. The Stopler-Samuelson theorem explains the relationship between changes in prices of goods and changes in prices of the factor of production such as wages and interest within the framework of the H-O theorem. The theorem states that if the price of the capital-intensive good increases then the price of capital will also increase, but the wages paid to labour will fall. Thus, if the price of machinery goods increases (assume machinery goods as capital-intensive) then the interest charged on capital would also increase. But at the same time, there will be a decrease in the wages of the labour. Similarly, if the price of labour-intensive goods increases then the wage rate would increase while the interest rate will fall.

The Stolper-Samuelson theorem was further extended by Jones, who developed the concept of 'magnification effect' for prices in the context of the H-O model. The magnification effect allows analysis of any change in the prices of both goods and provides information about the magnitude of the effects on wages and interest. Most importantly, the magnification effect allows one to analyse the
effects of price changes on real wages and real interest earned by workers and capital owners. This is crucial from the point of view of policy impact since real returns indicate the purchasing power of wages and rents after accounting for the price changes and thus are a better measure of well-being than simply the wage rate or rental rate alone.

This theorem is relevant in the age of globalization and trade liberalization. When trade liberalization occurs in a country, prices of goods change, and the magnification effect can be applied to seek an important result. A movement towards freer trade will cause the real return of the country's relatively abundant factor to rise, while the real return of the country's relatively scarce factor will fall. Thus, if the US and India are two countries that move towards free trade, and if the US is capital–abundant (while India is labour-abundant), then capital owners in the US will experience an increase in the purchasing power of their rental income while workers will experience a decline in the purchasing power of their wage income (i.e., they will lose). Similarly, workers will gain in India but capital owners will lose.

The reasons for this result are somewhat complex. When a country moves to free trade the price of its exported goods will rise while the price of its imported goods will fall. The higher prices in the export industry will inspire profit-seeking firms to expand production. At the same time, the import-competing industry suffering from falling prices, will want to reduce production to cut their losses. Thus, capital and labour will be laid-off in the import-competing sector but will be in demand in the expanding export sector.

However, a problem arises because the export sector is intensive in the country's (US) abundant factor, say capital – as per the H-O theorem. This means that the export industry wants relatively more capital per worker than the ratio of factors that the import-competing industry is laying off. In the transition, there will be an excess demand for capital, which will raise its price, and an excess supply of labour, which will bring down its price. Hence, the capital owners in both industries experience an increase in their rents while the workers in both industries experience a decline in their wages.

The theorem was originally developed to illuminate the issue of how tariffs would affect the incomes of workers and capitalists (i.e., the distribution of income) within a country because tariffs raise the domestic price of imported goods. However, the theorem is just as useful when applied to trade liberalization, as explained above. However, it should be kept in mind that these results have been derived in a model with only two goods and two factors that are perfectly mobile between sectors. This may not be valid in general. In particular, a factor employed in a sector where output declines (because of competition from imports) will suffer a loss in its real reward if it has no alternative source of employment.
1.7 FACTOR-PRICE EQUALIZATION THEOREM

According to the factor-price equalization theorem, when the prices of goods are equalized between countries due to international trade, the prices of the factors (i.e. capital and labour) also get equalized between countries. This implies that freer trade will equalize the wages of workers and the rentals earned on capital throughout the world in the ultimate analysis.

The theorem derives from the assumptions of the H-O model. The most critical is the assumption that the two countries share the same technology and that markets are perfectly competitive. In perfect competition, factors are paid based on the value of their marginal productivity, which in turn depends upon the prices of the goods. Thus, when prices differ between countries so will their marginal productivity, and hence so will their wages and rents. However, once prices of goods are equalized, as in free trade demonstrated earlier, the values of marginal products are also equalized between countries; hence, the countries must also share the same wage rates and rental rates.

However, it should be noted that the factor-price equalization is unlikely to apply perfectly in the real world. The H-O model assumes that technology is the same between countries to focus on the effects of different factor endowments. If production technologies differ across countries, as we assumed in the Ricardian model, then factor prices would not equalize once goods prices equalize.

Check Your Progress 4

Note: i) Use the space given below for your answers.
      ii) Check your progress with those answers given at the end of the unit.

1) Point out the main argument of the Stolper-Samuelson theorem.

2) Describe the magnification effect in the context of the H-O model.

3) Explain the main statement of Factor Price Equalization theory?
1.8 RYBCZYNSKI THEOREM

The Rybczynski theorem postulates that at constant commodity prices, an increase in the endowment of one factor will increase by a greater proportion of the output of the commodity intensive in that factor and will reduce the output of the other commodity. The theorem is useful in analyzing the effects of capital investment, immigration and emigration within the context of the H-O model.

Rybczynski's theorem can be understood diagrammatically with the help of figure 1.2. In Figure 1.2, EE reveals the labour constraints and while DD reflects the capital constraint. At point A, production takes place. Assume textiles as a labour-intensive good and software as a capital item and their production is depicted by $C_1$ $C_2$ for textiles and $S_1$ $S_2$ for software. Now, let us assume an increase in the wages of the labour, which causes an outward parallel shift in the labour constraint line from DD to $D_1D_1$. Here, the production possibility frontier also shifts from point A to point B. Production of textiles, the labor-intensive good, will shift from $C_1$ to $C_2$. Production of software, the capital-intensive good, will fall from $S_2$ to $S_1$.

![Diagram of Rybczynski theorem](image)

**Figure 1.2 Diagrammatic representation of Rybczynski theorem**

If the endowment of capital (interest rate) increases, the capital constraint will shift out, resulting in an increase in software production and a decrease in textiles production. As mentioned earlier, since the labour constraint curve is steeper than the capital constraint curve, the software is a capital-intensive item while textile is a labour-intensive item.

This means that in general, an increase in a country's endowment of a factor will cause an increase in the output of the good which uses that factor intensively and decrease the output of the other good.
Check Your Progress 5

Note: i) Use the space given below for your answers.

ii) Check your progress with those answers given at the end of the unit.

1) What does the Rybczynski theorem postulate?

2) Point out the important factors which could be analysed in the context of Rybczynski’s theorem.

3) Explain the main statement of Factor Price Equalization theory?

1.9 LET US SUM UP

After reading this unit, we have been exposed to the different international trade theories. We started with the theory of mercantilism, and then we understood the pure theory of international trade or absolute advantage theory coined by Adam Smith in 1776. After that, we learned the comparative advantage theory developed by David Ricardo in 1817. We learnt that both absolute advantage and comparative advantage theory considered labour as the only factor of production. Afterwards, we discussed Heckscher Ohlin's (H-O) Theory. Bertil Ohlin has drawn his ideas from Eli Heckscher's General Equilibrium Analysis. Hence, it is also known as Heckscher Ohlin (H-O) Theory. The unit also mentioned the extensions of the Heckscher Ohlin (H-O) model. Three more theories have been developed by extending the H-O model. The Stopler-Samuelson theorem explains the relationship between changes in prices of goods and changes in prices of a factor of production such as wages and interest within the framework of the H-O theorem. The theorem states that if the price of the capital-intensive good increases, then the price of capital will also increase, but the wages paid to labour will fall. Thus, if the price of machinery goods increases then the interest charged on capital would also increase. The unit also presents the Factor-Price Equalization Theorem. According to the factor-price equalization theorem when the prices of goods are equalized between countries due to international trade, the prices of the factors (i.e. capital and labour) also
get equalized between countries. This implies that freer trade will equalize the wages of workers and the rentals earned on capital throughout the world in the ultimate analysis. Finally, the unit concludes by discussing the Rybczynski theorem. The Rybczynski theorem postulates that at constant commodity prices, an increase in the endowment of one factor will increase by a greater proportion of the output of the commodity intensive in that factor and will reduce the output of the other commodity.

### 1.10 KEYWORDS

**International Trade**
The trade that takes place between buyers and sellers of two different nations is called international trade.

**Mercantilism**
It is the trade theory which postulates that countries should encourage exports and discourage imports. The theory argues that a nation should increase exports and reduce imports and export is the only way to accumulate wealth.

**Comparative advantage**
A country has a comparative advantage in producing a good ‘A’ if the cost of producing ‘A’ is lower at home than in the other country.

**Factor Endowments**
A country’s endowments with resources like land, labour, capital etc.

**Capital-Abundant Country**
A country well-endowed with capital is referred to as capital abundant.

**Magnification Effect**
The magnification effect allows analysis of any change in the prices of both goods and provides information about the magnitude of the effects on wages and interest.

### 1.11 SOME USEFUL REFERENCES


1.12 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1
1) Refer to Section 1.1
2) Refer to Section 1.2

Check Your Progress 2
1) Refer to Sections 1.3 and 1.4
2) Refer to Sections 1.3 and 1.4
3) Refer to Section 1.4

Check Your Progress 3
1) Refer to Section 1.5
2) Refer to Section 1.5
3) Refer to Section 1.5

Check Your Progress 4
1) Refer to Section 1.6
2) Refer to Section 1.6
3) Refer to Section 1.7

Check Your Progress 5
1) Refer to Section 1.8
2) Refer to Section 1.8