NOTES

For Part 1 Students

Paper- Macro Economics

TOPIC

International Trade

Role of International Trade in Economic Development

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Introduction

The buying and selling of goods and services across national borders is known as international trade. International trade is the backbone of our modern, commercial world, as producers in various countries try to profit from an expanded market, rather than be limited to selling within their own borders. International trade provides countries chance to be exposed to those services and goods that are not available in their own country.

Most nation of the world can be classified into three segments on the basis of development.

1. Underdeveloped- average real per capita income, high proportion of the labour force, low life expectancies, high rate of illiteracy high rate of population growth & low rates of growth in average real per capita income.

2. Developing- exporting primarily food and raw materials/ importing finished goods from developed nations.

3. Developed- exporting manufactured goods/ importing primary food and raw materials from developing nations.

Trade Theory and Economic Development

Broadly international trade theories can be classified into two types:

Classical Theories/ Traditional trade theory-
According to this theory if each nation specialises in the production of the commodity of its comparative advantage, world output will be greater and, through trade, each nation will share in the gain. It is based on number of assumptions related to various aspects like nature of markets, technology, demand, and returns to the scale etc.

Classical Theories

The Theory of Absolute Advantage- This theory was developed in 1776 by Adam Smith. He states that a country should export a commodity that can be produced at a lower cost than can other nations. Conversely , it should import a commodity that can only be produced at a higher cost than other nations.

The Theory of Comparative Advantage

This theory was developed by a British Economist David Ricardo which is an extension of the theory pf labour value and its application to the trade between countries. “The Labour Theory of Value” states that the relative prices of goods are determined by the amount of labour (with respect to labour wage) embodied in the goods.

The Theory of Reciprocal Demand

This theory was developed by John Stuart Mill an English Economist. Mill's theory considers demand side of international trade as both supply and demand matter foe trade to take place between countries. According to Mill within the limits set by comparative cost conditions, international value of goods traded will depend upon the strength of each country's demand for the other country's product.

Modern Theories

Factor Endowments Theory or Hecksher- Ohlin Theory.

International trade is based on differences in the prices as between nations.

Cost of production i.e payments to factor differ from country to country which are called as the factor prices.

Due to differences in the availabilities of factor of production, factor prices differ in different countries in relation to the demand of that country.

This theory concludes that differences in the comparative costs or advantages in countries can be on account of differences in the factor endowments.

Factor Price Equalization Theory

This theory is an extension of Hecksher-Olin theory and was developed by professor Samuelson in 1948. According to this theory, if country increases the production of a commodity using its abundant factor, the demand for the abundant factor will increase leading to price increase of that factor. Similarly, the demand for the scare factor will decline and bring down its price. Thus the price of two factors come together or converge in the same country.

Theory of International Factor Movements

In Today's modern world Multi National Corporations (MNCs) do transfer specific natural resources, factor services and technology, on account of their multi country operations.

Recent Development in Trade Theories

- Neo- Technology theories of trade emphasize technological innovations and technology gaps which exist between companies and countries as a major determinant of trade.

According to Intra Industry theory of trade, trade between countries occurs due to economies of scale and product differentiation.

International trade occurs due to policy intervention by the state. This intervention may be in the form of export subsidies, tac concessions, differential interest rates and domestic market protection through tariff and non- tariff barriers.

International trade has a major role in the economic development of any country.

- Through specialisation and increased world output, International trade expands the range of commodities available to the population.
- Trade leads to increased and more efficient use of a nation’s resources.
- International trade helps to attract foreign investment to exploit a country’s comparative advantage.

- Export-led growth creates linkage which stimulate the development of other industries.
- International trade may lead to the development of infrastructure such as roads, rials, power plants and telecommunication to facilitate trade.
- Foreign trade, especially the export may encourage the development of local entrepreneurs and skilled labour.
- International trade enhances the competitiveness of domestic industry.

The terms of Trade and Economic Development

The Various Terms of Trade

There are several other types of terms of trade, notably, the income terms of trade, the single factor terms of trade and the double factorial terms of trade.

For Example:

We define commodity, or net barter, terms of trade (N) as the ratio of price index of the nation's exports (P_x) to the price index of its imports (P_M) multiplied by 100 (to express the terms of trade in percentage).

That is: $N = (P_x / P_M)\ 100$

The Contributions of Trade to the Development

Even though international trade cannot in general be expected to be an “Engine of Growth” today, there are still many ways (besides the static gains from comparative advantages) in which it can contribute to the economic growth of today's developing nations.

Haberler, among others, has pointed out the following important beneficial effects that international trade can have on economic development.

- Trade can lead to the full utilisation of otherwise underemployed domestic resources.

- By expanding the size of the market, trade makes possible division of labour and economies of scale.

- International trade is the vehicle for the transmission of new ideas, new technology, and new managerial and other skills.

- Trade also stimulates and facilitates the international flow of capital from developed to developing nations.

- International trade is an excellent antimonopoly weapon it stimulates greater efficiency by domestic producers to meet foreign competition. This is particularly important to keep low the cost and price of intermediate or semifinished products used as inputs in the domestic production of other commodities.

- **THANK YOU**