

Explain the mechanism referred to in the above statement using the heckscher-ohli...

[Economics](#), [Trade](#)



“ Trade between advanced countries that are abundant in capital and skill and NIEs (Newly Industrialising Economies) with their abundant supply of unskilled labour was raising the wages of highly skilled workers and lowering the wages of less-skilled workers in the skill- and capital-abundant countries ” (Krugman, Obstfeld and Melitz). Explain the mechanism referred to in the above statement using the Heckscher-Ohlin model. The Heckscher-Ohlin model is extremely useful when illustrating how endowments of a particular resource can influence trade between economies.

The model shows us how comparative advantage is explained somewhat by the relative abundance of certain resources, such as land, labour or capital. The Heckscher-Ohlin (HO) model predicts that if a country is abundant in a factor of production then it will export the good whose production is intensive in that factor. For instance, if a country has an abundance of land relative to labour, then it will export goods that require land-intensive production, such as crop farming. Abundance, in this sense is defined as a ratio rather than an absolute value, and is therefore a ‘ relative’ term when comparing a two country model.

To illustrate the above statement, I will use a two country, two good, two factor model. I will name the advanced country, which has an abundance of skilled labour, ‘ Foreign’ and will name the newly industrialising economy, which has an abundance of unskilled labour, ‘ Home’. The foreign country produces only cars and the home country produces only shoes. Since producing cars requires a lot of skilled labour, Foreign’s production possibility

frontier relative to Home's is shifted more in the direction of cars relative to shoes.

This leads to Foreign producing more cars relative to shoes. The ratio of the price of cars relative to shoes is assumed to be constant due to trade resulting in the convergence of prices. If this is constant, then the relative supply of cars must be greater in Foreign than in Home. That is, the relative supply schedule for cars in Foreign lies to the right of that in Home, illustrated below. Assuming the demand schedule is identical in both countries, then without trade, Foreign's own market equilibrium is at ' 1' and Home's equilibrium for cars is at ' 2'.

When the two countries trade, the relative ' world' price converges to a point somewhere in between these two points at ' 3'. We can see from the above illustration that trade leads to a convergence of world prices at point 3. The Foreign economy will therefore export the good that has seen an increase in its relative price. Now that we have seen how prices change under the assumptions of the HO model, I will now explain how these changes have an impact on the distribution of income in countries open to trade.

A rise in the prices of cars increases the purchasing power of skilled labour (the abundant factor) in the foreign country in terms of both goods. At the same time it decreases the purchasing power of unskilled labour (the scarce factor) in terms of both goods. So by opening up to trade, the owners of the abundant factor become better off, whilst owners of the scarce factor become worse off. Theoretically, opening to trade should increase the consumption possibilities for the whole economy, allowing everyone to gain

a higher utility. So why do some people become worse off, post-trade under the HO model?

The underlying issue is that trade only changes relative prices of factors, which has a direct effect on the relative earnings of those who possess those factors. Particular industries require a particular composition of inputs, which in most cases is only a temporary problem, but a problem nonetheless. For instance, the shoemaker in the above example cannot simply start producing cars with their limited skill set. This immobility of factors means that those who possess the scarce factor cannot quickly or easily substitute their factor for an abundant factor.

This widens the earnings gap between these two groups, which in many cases increases economic inequality. The Heckscher-Ohlin model, unlike the Ricardian model, predicts that factor prices equalise after trade. This is because of the direct relationship between relative prices and factor prices, and due to the fact that relative prices equalise. However, it is important to state that this is a model and does have its limitations when it comes to testing the theory. The model predicts that the two countries produce the same goods, but in reality, countries may produce different goods and may trade with more than one other country.

The model also assumes that all countries have the same technology and the same productivity of factors. Again, in reality, economies will have differing levels of technology and will have different productivity levels, which will affect the rates and wages paid to these factors. Transport costs and trade barriers may also prevent the prices of factors and goods equalising. The

effect of trade on the widening of inequality has been a topic of interest among economists in recent years. Empirical evidence seems to support the Heckscher-Ohlin model.

Income inequality has risen in the U. S. considerably from the period 1967 to 2007. For this period the Gini coefficient, a measure of income inequality, has risen from 0. 39 to 0. 47. <sup>1</sup> This is a significant increase and does imply that inequality in the U. S. has risen during this period. But this measure does not explain the cause of the increase. Many economists feel that the effect due to trade is relatively small as there are a huge number of other factors that contribute to this statistic, such as domestic policy.

Support of the HO model through empirical evidence is weak. However, the evidence was stronger for manufacturing data between low/middle income countries and high-income countries. <sup>2</sup> Trefler (1995) suggested that the lack of support of the model might be due to differences in technology and productivity. His findings stated that the HO theory was an excellent model for international trade when, and only when, many of the initial assumptions are relaxed, such as the homogeneity of technology endowment.