Introduction to theories of international trade

In this concept there are mainly two theories that are classical theory of trade and new trade theory each differentiates from each other with different advantages, assumption and drawbacks. Exchange of goods and services on an international level between two or more countries is stated as international trade. Trade generally takes place between different companies it is of different goods and services. An import is goods and services bought by other country for local use. Example: UK imports gold, telecom equipment from India and export is the process of selling the goods and services which the host country has produced in the country more than sufficient. Example: Tea is exported to UK from India. However, government and individual person often buy and sell products and services internationally resulting international trade. Integration of the world economy is more than ever before. We participate in world/global economy by purchasing or selling goods and services in day to day life. Industrial equipments, oil, agricultural products, services like banking transportation, telecommunication, and tourism services are main part of international trade commonly. International transportation and communication cost has been reduced significantly resulting in greater integration between the economies of the world. The interdependence of countries can affect prices, wages, employment, and production in other country; it also affects economic trends and financial condition of each other. For prosperity countries have to work together more closely and rely on each other.

Classical Trade theory:

Classical theory focused mainly on occurrence of trade. The firms felt need of a separate theory due to fundamental differentiation of internal trade.

These theories feature the variation in comparative benefit of manufacturing commodities of 2 countries to the diversity in the manufacturing competence of workers in that particular country it is focused on single value prices. Factor price differences are never considered in this theory. There are several sub theories in this particular concept which is explained as followed. (Sinha, n. d.)

Absolute advantage Theory of trades (Adam smith, 1776):

In the 2nd part of the 18th economic progress got complicated due to mercantilism policies. In the book “ The Wealth of Nations” published in 1776 author Adam Smith stated that mercantilism theory favors the producers and reduces the interest of the consumers. Adam smith says in his theory that exports are profitable but countries should also import goods and services to satisfy better requirements of consumers instead of making them here in internal market. As we can see in the figure 1, “ country 1” has absolute advantage in “ good A” production/resources and “ country 2” has absolute advantage in “ good B” production/resources so “ country 1” should export “ good A” to “ country 2” and import “ good B” from “ country 2” vise versa. (Anon, n. d.)

Figure 1: Absolute Advantage (Absolute Advantage n. d.)

Assumptions of absolute advantage theory:

Trade between two countries for two commodities: – If we take three or more countries it does not help analytically for absolute advantage theory.

Efficiency of the product: – Country's goal is not always efficiency comparing at the level of the world it is not easy to produce efficient product every time.

Zero transportations cost: – Transportation cost is not considered in absolute advantage theory.

Factor mobility/immobility: – Theory presumes that all the resources are mobile in the country and immobile between two or more countries.

Total employment: – Theory considers that every country has full employment in the whole country. (Anon, n. d.)

Comparative advantage Theory (David Ricardo, 1817):

This theory of David Ricardo states that both the countries involved in trade can gain a lot even if one of the countries is producing less than all goods and services that produced by other country. As can be seen in the graph below country B is producing more than country A in both the goods that is produced in both countries. Both the counties should specialize in what there is low opportunity cost is required. (Anon 1, n. d.)

Figure 2: Comparative Advantage (Comparative Advantage n. d.)

No or low transportation cost: – consideration of the transportation cost is not even taken in this theory also.

No negative externalities: – theory does not say about externalities affecting trade, and it also does not take into consideration that there could be negative externalities for more production. (Anon 2, n. d.)

There are no economies of scale: – Due to different policies of government for particular country it becomes hard to trade freely and affects the total production and eventually affecting to the scale of economy. (Anon 3, 2008)

Mercantilism Theory (16th century):

Mercantilism theory is a thinking of 16th century. Major trading nations were thinking that if we increase our exports internationally we will gain power, wealth and also the precious metals like gold and silver in return. The theory says that in total world there was only fixed wealth which will increase our countries wealth resulting in becoming powerful country through either importing or exporting the goods in high quality but in lower cost. Earlier days transactions was use to take place in the form of either in gold or in silver coins which created trend of exporting more and importing less is called as mercantilism. (Anon1, n. d.)

Mercantilism is time bounded; it is short term because after some period of time resources will be over due to large no of use of the raw material. Then countries will have to import the same good to their own country.

Certain goods should be imported by any country to avoid later effect of scarcity for any goods and services. (Anon 4, 2008)

Factor Endowments Theory (Heckscher in 1919, Ohlin in 1933):

In this theory both Swedish economists Heckscher and Ohlin have different view/explanation about comparative advantage. They both think that comparative advantage comes from difference in national factor endowments. Factor endowments means the scope of the country is endowed with resources like land, labor, and capital, workforce, and infrastructure. Different countries have different factors endowed, and different factor endowments explain differences in factor costs. To lower the cost the factor should be more profuse. This theory proposes that the nations would export those goods that makes demanding use of those factors that are locally more in numbers, and should import those goods those have scarcity locally. (Aswathappa, 2010)

New trade theory:

This theory endeavor to comprehend and give details of the global trade affect the diversity of goods accessible to consumer around the world, these theories also describe concentration of market structure.

Analysis of Trade:

The testimony brings the awareness that the trade between India and U. K has historical trade relations. India's exports to U. K was beneficial to both countries as U. K use to import raw material and make it into finished goods and again export those products to other countries. According to the survey it is observed that India had good revenue when the exports were high to U. K but as India moved towards diversification the exports of the country started declining since the year 2000. Both countries are the top investors in the economies of each others economies, this enables long term benefits to both countries. (Anon 5, 2012)

Exports of India:

The current situation of India's exports shows positive sign on the trade i. e. exports of the country was worth 23698 million USD. In the GDP 22% of exports is been contributed, out of which jewelry constitutes 16% of contribution in exports. Mainly India exports to U. S, European Union, China Arab Emirates. (Tradingeconomics 1, 2012)

Exports of U. K:

The current market situation of U. K according to the records is 40. 5 Billion GBP in September 2012. This country is considered as fifth largest nation. The main export of U. K is telecommunication equipment, aircrafts, automatic data processing equipment etc. U. K mainly exports goods and services to Ireland, USA, France and Germany. (Tradingeconomics 2, 2012)

Positive impacts of International trade on India and U. K:

The growth of India rose above 6% after the year 2000.

Overall employment also increased from 1% to about 3% which is beneficial to the economy.

Liberalization of trade policies enabled to bring efficiency in several terms.

Improved standard of living of the country. (Sankaran, Abraham, and Joseph, n. d.)

Increase in possible growth of the business.

Expand market share globally.

Enables steady variation of market.(Economywatch, 2010)

Protectionism of trade theory:

This concept came into existence in order to protect the interest of the country who is involved in international trade. Here government protects the firms from exploitation of other countries. Typical method of protectionism is direct state intervention, subsidies, tax cuts to local business, quotas and tariffs. These are main types of protectionism method used by the government.

Merits of protectionism:

Protectionism of international trade helps protecting the local organization and employment. With help of reduction in imports economical aggregate demand will increase.

Country can develop some laws to avoid dumping. Foreign companies bring their products and sell them in lowest price than the production cost.

Protectionism helps in developing new domestic firm to grow faster blocking the foreign company to develop locally. (Gulrajani, 2009)

Demerits of protectionism:

Innovation and improvement will become weak as there will not be much of competition due to protectionism.

Dismissal and burnout will be the ultimate result of protectionism.

Lower or bad quality might dissatisfy the customers because of long term protectionism.

Redundancy can become serious issue due to less innovation or improvement.

Protectionism affects the countries economy and also the world economy. Many countries are now avoiding protectionism ad they are favoring more of free trade agreements. (Anon 8, n. d.)

Analysis of Comparative Advantage:

At a lower opportunity cost when a country produces goods and services when compared with other country that particular country is said to have comparative advantage. (Economicshelp, n. d.)

Comparative advantage of India:

India has huge population therefore this particular country has good labor and so it is specialized in labor intensive product. This capability differentiates themselves from other countries, and makes maximum use of it in order to make maximum profits which would add to host countries economy. (Tradingeconomics 3, 2012)

Comparative advantage of U. K:

U. K is vast country therefore they are specialized in several goods but mainly the comparative advantage of this country is manufactured goods i. e. is pharmaceutical products, telecommunication product etc. the quality provided by this country for these country makes product outstanding also the technologies use to manufacture these product ensure efficiency in goods that exported. (Economicsonline, n. d.)

Criticism to Comparative advantage:

Even if the countries do not have clear comparative advantage, they aim to take risk by broadening there horizons for goods and services.

The assumption of two country and two goods is incorrect as the real world is too complex by exporting and importing different services and goods.

This concept is not constant i. e. it can change over a period of time.

In this concept exchange rates and relative prices are not taken into consideration.

Structural unemployment is possible if there is complete specialization as there are some cases where workers cannot transfer from one sector to another.

Without any diminishing return this concept is perfectly mobile. (Economicsonline, n. d.)

Conclusion:

International trade and investment is constituted by economic relation. This irregularity is embedded in a situation where prosperous countries are impatient to stipulate free trade for others but are hesitant to compel it on themselves and are capable to evade doing so. The current market of international trade promotes growth and aims to reduce poverty. Different theories have different assumptions but the modern theory is considered to be more effective then the other as it focuses on both i. e. exports as well imports. The protectionism concept is effectively being used by the countries in order to avoid exploitation and also ensures smooth going in trade.