School of Finance and Commerce

Course Code : BCOM2019

Course Name: INTERNATIONAL BUSINESS

International Trade Theories

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Program Name: B.Com (Hons.)

Lecture - 3

Topic covered

- Theory of Mercantilism
- Theory of Absolute Cost Advantage
- Assumptions of Theory of Absolute Cost Advantage

Introduction

Economists have suggested several theories to explain why there should be trade between nations and what goods should a country export or import.

Propagated in the 16th and 17th centuries - Mercantalism advocated that countries should simultaneously encourage exports and discourage imports. Proposed in 1776, Smith’s theory was the first to explain why unrestricted free trade is beneficial to country.

Introduction

Building on Smith's work are two additional theories.

One is the theory of comparative advantage, advanced in the 19th century by Englsih economist David Ricardo.

In the 20th century, Ricardo's work was refined by two Swedish economists, Eli Heckscher and Bertil Ohlin, whose theory is known as Heckscher-Ohlin theory.

Theory of Mercantilism

- This theory is during the sixteenth to the three-fourths of the eighteenth centuries.
- It beliefs in nationalism and the welfare of the nation alone, planning and regulation of economic activities for achieving the national goals, curbing imports and promoting exports.
- It believed that the power of a nation lied in its wealth, which grew by acquiring gold from abroad.

Theory of Mercantilism

- Mercantilists failed to realize that simultaneous export promotion and import regulation are not possible in all countries, and the mere possession of gold does not enhance the welfare of a people.

- Keeping the resources in the form of gold reduces the production of goods and services and, thereby, lowers welfare.

- • It was rejected by Adam Smith and Ricardo by stressing the importance of individuals, and pointing out that their welfare was the welfare of the nation

Theory of Absolute Cost Advantage

This theory was propounded by Adam Smith (1776), arguing that the countries gain from trading, if they specialise according to their production advantages.

Smith established the hypothesis of Absolute Advantage, which holds that various nations produce a few products more proficiently than different nations; in this manner worldwide productivity can increment through free trade.

He reasoned that if trade were unrestricted, each country would specialize in those products that gave it competitive advantage.

Theory of Absolute Cost Advantage

Such efficiency is gained through:

a) Repetitive production of a product, which increases the skills of labour force

b) Switching production from one produce to another to save labour time.

c) Long production would provide incentives for the development of more effective working methods.

Theory of Absolute Cost Advantage

A country could use its excess specialized production to buy more imports than it could have otherwise produced. A country's advantage may be either Natural or Acquired.

a) Natural advantage : A country may have Natural Advantage in producing a product because of climatic conditions, access to certain natural resources or availability of certain labour forces.

b) Acquired Advantage : Most of the world's trade today is of services and manufactured goods rather than agricultural and goods and natural resources.

Assumptions of Theory of Absolute Cost Advantage

- There are two countries;
- There are two commodities;
- One factor of production (i.e. labour)
- Costs of the commodities were computed by the relative amounts of labour required in their respective production processes.

Assumptions of Theory of Absolute Cost Advantage

- Labour is mobile within a country but immobile between countries.
- Any trade between the two countries considered would take place if each of the two countries has an absolutely lower cost in the production of one of the commodities.

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Thank You