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BA Economics Honours | Semester V | Calicut University

International Trade Theories

Course Code: ECO5CJ302 • Module 2

Module II: Traditional Theories of International Trade

Classical trade theories explain the causes and consequences of trade through variations in labor productivity, natural resource endowments, and absolute or relative cost differences.

Unit 7 & 8: Mercantilism and Adam Smith's Absolute Cost Advantage

- **Mercantilist Doctrine (16th–18th Century):** Viewed international trade as a zero-sum game ($Gains = Losses$). Mercantilists advocated state promotion of exports and rigorous restriction of imports to accumulate precious metals (bullion: gold and silver) as the primary index of national power.
- **Adam Smith's Absolute Advantage (1776):** Refuted mercantilism in *The Wealth of Nations*, demonstrating trade is a positive-sum game. Smith postulated that if Country A can produce good X with fewer labor hours than Country B, and Country B can produce good Y with fewer labor hours than Country A, both countries benefit by specializing in their absolute advantage commodity and trading.

Unit 9, 10 & 11: Ricardo, Haberler, and Mill's Reciprocal Demand

- **David Ricardo's Comparative Advantage (1817):** Demonstrated that even if one nation holds an absolute productivity advantage in every commodity, mutually beneficial trade remains possible if each nation specializes in the commodity in which it possesses a **lower relative opportunity cost**. Comparative advantage is determined by relative labor cost ratios:

$$\frac{a_{1L}}{a_{2L}} < \frac{a^*_{1L}}{a^*_{2L}}$$

- **Gottfried Haberler's Opportunity Cost Theory (1936):** Liberated Ricardian trade theory from the restrictive Labor Theory of Value. The cost of producing an extra unit of good X is measured by the quantity of good Y that must be surrendered, represented by the Marginal Rate of Transformation (MRT) along the PPF under constant, increasing, or decreasing opportunity cost conditions.
- **John Stuart Mill's Theory of Reciprocal Demand (1844):** Ricardo determined the limits within which the international terms of trade must lie; Mill determined the exact equilibrium terms of trade within those limits through **reciprocal demand**—the strength and elasticity of each nation's demand for the other country's export good.

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

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Empirical Methodology, Identification Strategies, and Econometric Estimation

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Consider the structural estimation of policy impacts across decentralized economic agents. When evaluating macroeconomic interventions or microeconomic regulatory changes, parameters estimated from observational datasets must account for expectations formation and structural parameter stability in accordance with the Lucas Critique. Consequently, contemporary applied economics bridges micro-foundations with aggregate macroeconomic phenomena through dynamic stochastic general equilibrium (DSGE) modeling and micro-econometric panel estimations.

Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

Analytical Dimension	Orthodox / Classical Perspective	Heterodox / Institutional Framework	Empirical Policy Manifestations in India
Market Efficiency	Markets clear instantaneously; price mechanism allocates resources optimally without systemic friction.	Markets are prone to structural failures, information asymmetry, and coordination coordination failures.	Targeted regulatory oversight, public investment in infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
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Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

Policy Synthesis and Analytical Evaluation

Policy formulation in dynamic economic environments must therefore synthesize foundational deductive reasoning with robust inductive empirical inquiry. Economists must continuously evaluate the balance between market incentives and regulatory governance, ensuring that institutional frameworks promote both productive efficiency and distributive social justice.

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