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BA Economics Honours | Semester V | Calicut University

International Trade Theories

Course Code: ECO5CJ302 • Module 4

Module IV: New Theories of International Trade

While classical and neoclassical theories explain inter-industry trade between dissimilar economies based on comparative advantage, contemporary trade flows among similar industrialized nations are dominated by **Intra-Industry Trade** (simultaneous export and import of differentiated products within the same industry).

Unit 18, 19 & 20: Dynamic Technology Models of Trade

- **Posner's Technological Gap Model (Michael Posner, 1961):** Trade flows are generated by technological innovations that give firms in one country a temporary monopoly. Trade persists during the time lag required for foreign producers to imitate the technology (*Imitation Lag* minus *Demand Lag*).
- **Vernon's Product Life Cycle Theory (Raymond Vernon, 1966):** Tracks the cross-border relocation of manufacturing across three sequential stages:
  1. *New Product Stage:* High R&D, unstandardized production, manufactured domestically in the innovating advanced country.
  2. *Maturing Product Stage:* Mass standardization, growing export demand, foreign branch plant investment.
  3. *Standardized Product Stage:* Production becomes routine; low labor costs dictate relocation to developing nations; the original innovating country becomes a net importer.
- **Kravis's Theory of Availability (Irving Kravis, 1956):** Nations export goods that are readily "available" domestically due to unique natural resources or technological leadership, and import goods unavailable domestically due to complete inelasticity of domestic supply.

Unit 21 & 22: Krugman Intra-Industry Trade and Neo-H-O Models

- **Paul Krugman's New Trade Theory (1979 - Nobel Prize 2008):** Explains intra-industry trade among identical economies through the synergy of **Monopolistic Competition** and **Internal Increasing Returns to Scale (Economies of Scale)**. Consumers have a love-of-variety preference (Dixit-Stiglitz preferences). International trade enlarges market size, enabling firms to achieve lower average unit costs through economies of scale while expanding the total variety of differentiated goods available to consumers.
- **Neo-Heckscher-Ohlin Theories:** Augment the basic H-O model by integrating human capital skills, natural resource disaggregation, intermediate inputs, and heterogeneous firm productivity (Marc Melitz model).

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.

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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

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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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