[Frequently Asked Questions]

Extension of H.O. Theory

Subject:	Business Economics
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Paper No. & Title:	Paper – 541 International Economics
Unit No. & Title:	Unit – 4 New Topics in International Trade
Lecture No. & Title:	2 (Two) Extension of H.O. Theory

Frequently Asked Questions

1)State the highly restrictive assumptions on which H-O theorem is based?

The highly restrictive assumptions on which HO theorem is based are that there are two countries where quantities of labour and capital are fixed, tastes are unchanged, technology and returns to scale are constant and transport costs are zero.

2)What happens when there are changes in factor endowments of a country?

When there are changes in factor endowments of a country, given no change in technology, they bring about changes in output, volume of trade, income, employment, terms of trade and gains from trade between the two trading countries.

3) What is the impact on volume of trade when there is an increase in the supply of labour of a country?

If a country exports commodity X, an increase in the supply of its relatively abundant labour endowment tends to increase the volume of its exports.

4) What is the impact on national income of a country if there is an increase in supply of labour?

An increase in the supply of labour and consequently outward shifting of the production possibility curve(PPC) implies an increase in the national income of country.

5)What is the impact on employment of a country if there is change in one factor endowment (supply of labour)?

Given factor and commodity prices, when the supply of labour increases in country, there will be transfer of labour from capital intensive to labour intensive industry. Thus leading to rise in employment.

6)What is the impact on output if supply of labour increases in one country and remains constant in other?

Suppose the supply of labour endowment increases in country A only and remains constant in country B. Commodity prices remaining constant, an increase in the supply of labour increases the output of country A producing labourintensive commodity X and reduce the capital-intensive commodity Y (country B).

7) The H.O theorem assumes trade is only possible when there is constant returns to scale in the production of two commodities that are traded by two countries. True or false.

The H.O theorem assumes constant returns to scale in the production of two commodities that are traded by two countries. This is unrealistic because cost functions in many developed countries have decreasing costs or increasing returns to scale. If commodities are produced under decreasing costs or increasing returns to scale, trade is possible between the two countries.

8) What is the impact on changes in tastes of a country?

If a country's tastes change, given its technology and factor endowments. It will alter its volume of trade and terms of trade. If a country's tastes changes from its exportable to importable commodity, its volume of trade increases and its terms of trade declines. On the contrary, a change in tastes from its importable to exportable commodity reduces its volume of trade and improves its terms of trade.

9) Is zero or no transport costs assumption of H-O theory realistic?

The H.O. theory assumes zero or no transport costs. This is unrealistic because transport costs are important in their impact on the price of a traded commodity, its production and consumption and volume of trade in two trading countries. Transport costs include all expenses incurred in transporting a commodity from one country to another. They include loading, unloading and freight charges, insurance premium and interest costs. With the inclusion transport costs, a commodity will be traded only if the price difference between two countries before trade is more than the cost of transporting it.

10) According to H-O theory how will trade exists when there are constant returns to scale between two countries?

A capital-abundant country will export the capital-intensive good, while the labour-abundant country will export the labour-intensive good.