[FAQ]
[Factor Price Equalization Theory]

Subject:	Business Economics
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Unit No. & Title:	Unit - 2 Factor Endowment and Heckscher-Ohlin Theory
Lecture No. & Title:	2: Factor Price Equalization Theory

FAQ:

(1) Who gave the concept of factor price equalization theorem?

A. Paul Samuelson has given the concept of factor price equalization.

(2) What will be the most immediate effect of international trade?

A. The most immediate effect of international trade is that it would equalize relative commodity prices in both nations.

(3) Why the prices of commodities differ in different nations?

A. The prices of commodities differ because factor endowments in different nations are different.

(4) Give the definition of factor price equalization theorem.

A. International trade will equalize the relative and absolute prices of factor of production across nations.

(5) Explain the assumptions of H-O-S theory.

The assumptions of H-O-S theory are as follows:

(a) There are only two countries, two goods and two factors of production. This model is known as **2x2x2 model.**

(b) There is a **perfect competition in goods market** which means that price is determined by the industry and producers and consumers cannot affect the market price.

(c) There is a **perfect competition in factor market** which means that neither labor nor capital has the power to affect prices or factor rewards.

(d) There is a **full employment** in both nations.

(e) There is a **constant return to scale (CRS).** It exhibits that doubling the inputs (labor and capital), output will increase by twofold. We can say that production function is homogenous of degree one. If we double the amount of labor and keep capital constant, output will increase less than the increase in the amount of labor. It shows the diminishing returns to labor. Similarly, there are is diminishing returns to capital also.

(f) We can know the abundance of goods. One cannot change the abundance of the goods.

(g) There is **free trade** between two nations. There are no restrictions like tariffs, quota etc.

(h) The **factors of production** completely **mobile within the nation**. But they cannot move from one nation to another. Therefore, **international mobility does not exist.** We can say that one labor can move from Mumbai to Ahmedabad but he or she cannot move from Mumbai to New York.

(i) **The production function of two goods is different but they are same in both nations.** It means that production function of good X is same in both nations and production function of good Y is same in both nations. But production functions of X and Y are different in both nations.

(j) The factors affecting demand like tastes, preferences and income are assumed to be constant.

(k) The stock of the factors of production in both nations is constant. They are homogeneous.

(6) Elucidate H-O-S theorem.

A. International trade will equalize the relative and absolute prices of factor of production across nations. We assume that,

Two nations: A and B and Two commodities: X and Y.

(a) Nation A is capital abundant nation and nation B is labor abundant nation. Commodity X is capital-intensive and commodity Y is labor-intensive. Therefore, nation A can produce more of X and nation B can produce more of Y.

(b) It means that price of commodity X is lower in nation A than in nation B because the relative price of capital, or interest rate(r), is lower in nation A in the absence of trade. Similarly, price of commodity Y is lower in nation B than in nation A because the relative price of labor, or wage rate (w), is lower in nation B in the absence of trade.

(c) After having trade with nation B, nation A will specialization in commodity X. Nation A increases the production of X and therefore demand for capital will increase which in turn raises the rate of interest. The relative demand for labor declines, causing the wage rate to fall.

(d) After having trade with nation A, nation B will specialization in commodity Y. Nation B increases the production of Y and therefore demand for labor will increase which in turn raises the wage rate. The relative demand for capital declines, causing the interest rate to fall.

(e) In autarky situation,

Nation A: r is lower

w is higher

Nation B: r is higher

w is lower.

(f) International trade causes interest rate to rise in nation A (low interest rate nation) in which r was lower in autarky situation. Similarly, international trade will increase the wage rate in nation B (low wage nation) in which w was lower in absence of international trade. Thus, we can say that international trade reduces the pre-trade difference in wage rate and rate of interest between two nations.

(g) The international trade will keep increasing until relative commodity prices are completely equalized; it means that relative factor prices have also become equal in the two nations.

(7) Explain Euler's theory.

A. According to Euler's theorem, total production will be just exhausted if all factors are paid rewards equal to their marginal products.