Heckscher - Ohlin Theorem

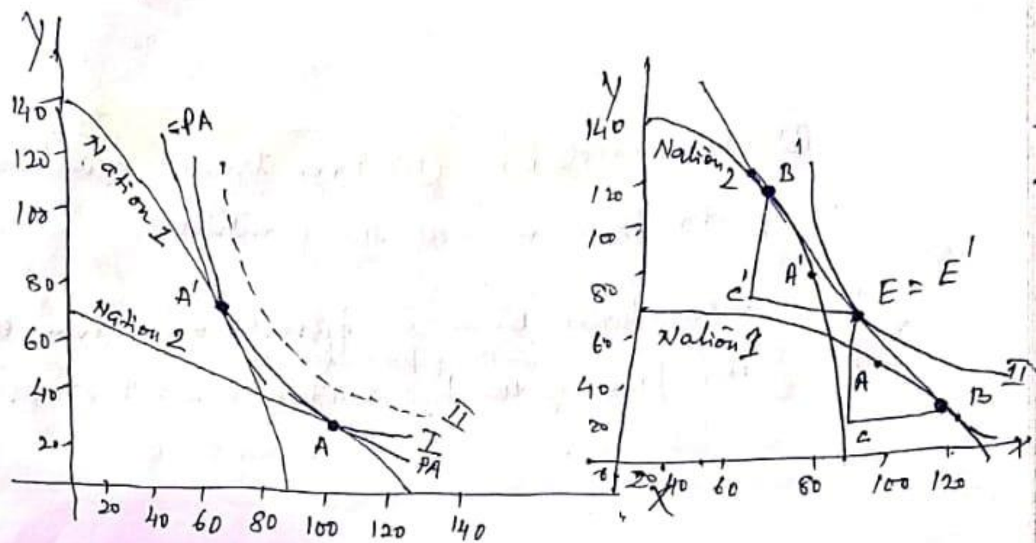
This theory can be presented in a nutshell in the form of two Theorems — H.O. theorem (which deals with and predicts the pattern of trade) and the factor-price equalisation Theorem (which deals with the effect of international trade on factor prices)

= H.O. Theorem states " A nation will export the commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and imports the commodity whose production requires the intensive use of the nation's relatively scare and expensive factor.

= That the countries that are rich in capital will export capital intensive goods and the countries that have much labour will export labour intensive goods.

= It means that Nation 1 export commodity X because commodity X is the labour-intensive commodity and L is relatively abundant and cheaper in Nation 1. Conversely, Nation 2 exports commodity Y because commodity Y is the capital intensive commodity is capital is relatively abundant and cheaper in Nation 2.

= Of all the possible reasons for differences in relative commodity prices and comparative advantage among nations, the H.O. theorem isolates the difference in relative factor endowments among nations.



H.O. Model

Indifference curve is common to both nations because of the assumption of equal taste. Indifference curve is tangent to the production frontier of Nation 1 at point A and tangent to the production frontier of Nation 2 at point A'. This defines no-trade equilibrium - relative commodity price of P_A in Nation 1 and $P_{A'}$ in Nation 2. Since $P_A < P_{A'}$, Nation 1 has a comparative advantage in commodity X and Nation 2 in commodity Y.

With Trade (right panel) Nation 1 produces at point B and by exchanging X for Y reaches at point E in consumption. Nation 2 produces at B' and by exchanging Y for X reaches at point E' (which coincides with E). Both Nations gain from trade because they consume on higher indifference curve II →

Factor Price Equalisation

= International trade will bring about equalisation in the relative and absolute returns to homogeneous factors across the nations. As such international trade is a substitute for the international mobility of factors.

(I) Free Mobility (II) Free trade equalises the factor price in both the countries.

= International trade is possible only when the relative factor price of factors of production in ~~the~~ two countries are not same.

Assumptions

1. There are no transport costs or other impediments to trade.
2. There is perfect competition in both the ~~countries~~ commodities and factor market.
3. All production functions are homogeneous of the first degree.
4. The Production functions are such that the two commodities show different factor intensities.
5. The production functions differ ~~does~~ between commodities, but are same in both countries, i.e. good A is produced with the same technique in both countries and good B is produced with the same technique in both countries.

6.

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