Neoclassical Model of International Trade

Definition of The Neoclassical Model of International Trade

The Neoclassical Model of International Trade is an economic theory that explains international trade patterns based on countries' comparative advantages and the availability of production factors (such as labor, capital, and land). It assumes that countries specialize in producing goods they can make most efficiently relative to others, leading to mutual gains from trade and an overall increase in economic welfare.

Concepts of the Neoclassical Model

A. Comparative Advantage

- Definition: A country should produce and export goods it can make relatively more efficiently.

B. Factor Proportions / Heckscher-Ohlin Theory

- Trade patterns depend on countries' resources (labor, capital, land).
- Countries export goods that use their abundant factors intensively.
- Example:
    - A capital-rich country exports machinery; a labor-rich country exports textiles.

C. Assumptions of the Model

- Perfect competition
- Constant returns to scale
- Full employment of resources
- No transport costs or trade barriers

D. Gains from Trade

- Trade allows countries to consume beyond their production possibility frontier (PPF).
- Both countries' welfare increases.

E. Price Equalization

- Free trade tends to equalize relative prices of goods and factors across countries.

Limitations of the Model:

- Ignores transportation costs, tariffs, and trade barriers.
- Assumes perfect competition and full employment, which rarely occur in reality.
- Does not account for technological differences or political factors.