Heckscher-Ohlin Theory

Heckscher-Ohlin Theory states that "A nation will export the commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and import the commodity whose production requires the intensive use of the nation's relatively scarce and expensive factor."

Assumptions

1- There are two nations (Nation 1 and Nation 2), two commodities (commodity X and commodity Y) and two factors of production (labour and capital).

2- Both nations use the same technology in production.

3- Commodity X is labour intensive and commodity Y is capital intensive in both nations.

4- Both commodities are produced under constant returns to scale in both nations.

5- There is incomplete specialization in production in both nations.

6- Tastes are equal in both nations.

7- There is perfect competition in both commodities and factor markets in both nations.

8- There is perfect factor mobility within each nation but no international factor mobility.

9- There are no transportation costs, tariffs or other obstructions to the free flow of international trade.

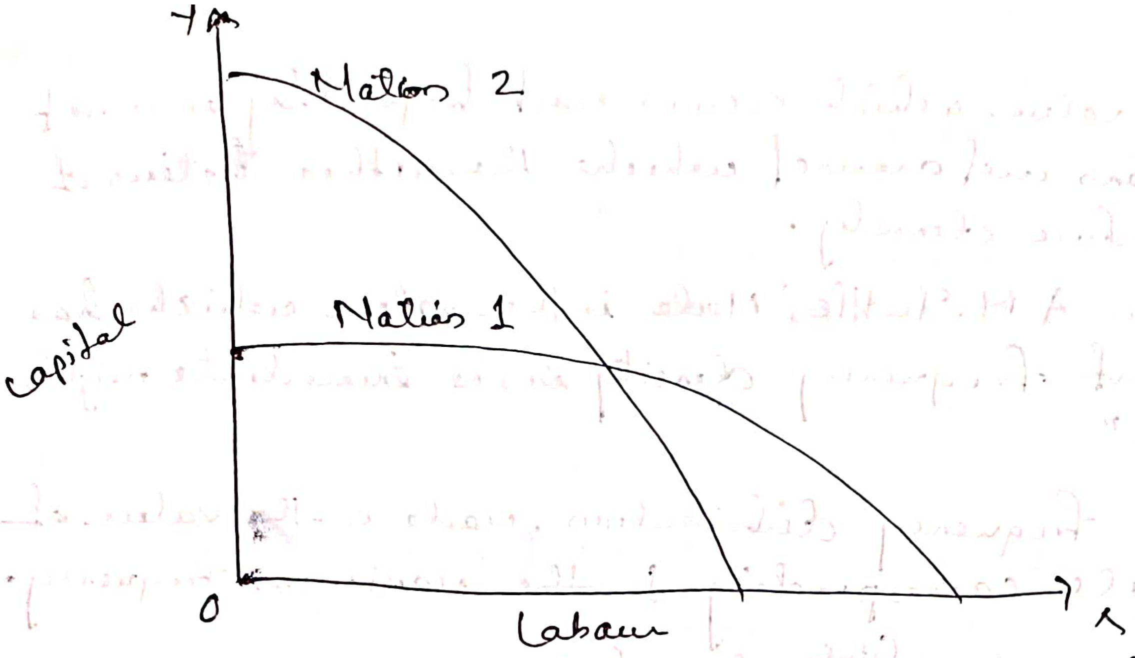
10- All resources are full employed in both nations.

11- International trade between the two nations is balanced.

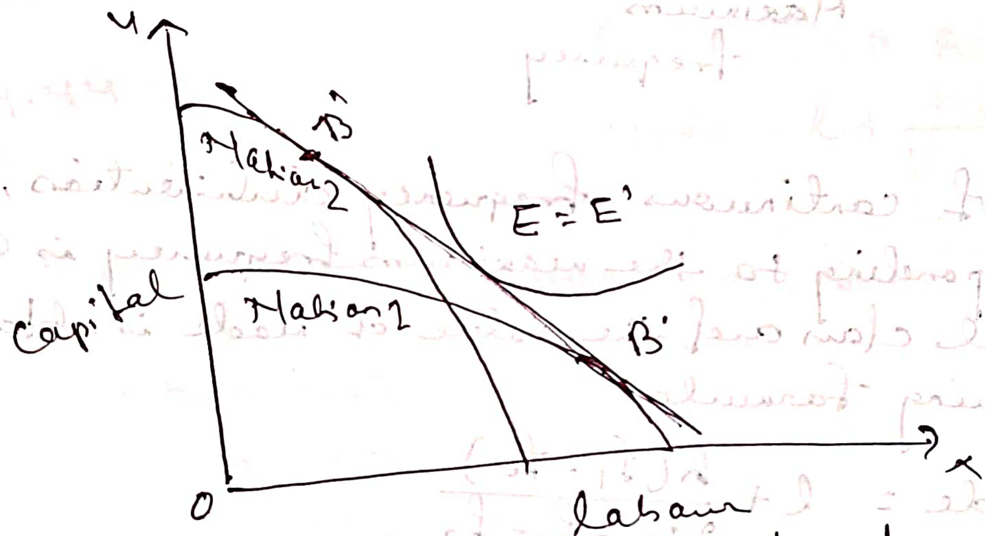
In a world of two commodities (X and Y) and two factors, commodity Y is capital intensive if the capital-labour ratio (K/L) used in production of Y is greater than K/L used in the production of X.

If two units of capital (2K) and two units of labour (2L) are required to produce one unit of commodity Y, the capital-labour ratio is one. If at the same time 1K and 4L are required to produce one unit of X, $K/L = 1/4$ for commodity X. Since $K/L = 1$ for Y and $K/L = 1/4$ for X, we say that Y is K intensive and X is L intensive.

As Nation 2 is the K-abundant nation and commodity Y is the K-intensive commodity, Nation 2 can produce relatively more of commodity Y than Nation 1. On the other hand, since Nation 1 is the L-abundant nation and commodity X is the L-intensive commodity, Nation 1 can produce relatively more of commodity X than Nation 2.



Since Nation 1 is the L- abundant nation and commodity X is the L- intensive commodity, Nation 1's production frontier is skewed towards the horizontal axis and vice versa.



Nation 1 has comparative advantage in commodity X and Nation 2 in commodity Y. With trade Nation 1 produces at point B and by exchange X for Y reaches point E in consumption. Nation 2 produces at B' and by exchange Y for X reaches point E'. Both Nation gain from trade because they consume higher IC.

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