

3. Changes in the Composition of Trade: Some Formal Views

The popular **Heckscher-Ohlin theory** of international trade argues that the composition of a country's trade is determined by its **supply capabilities**, which reflect differences in factor proportions across countries. For Canada, the Heckscher-Ohlin model would predict that because of its relatively low cost of natural resources, Canada is likely to export resource-intensive goods—supporting the view that Canada will forever be dependent on exports of natural resources.

Removing tariffs on manufactures moves a country to dependence on natural resources. Prior to 1988, Canada used tariffs to persuade foreign corporations to locate manufacturing in Canada. Some observers have argued that the removal of this tariff wall under the FTA, NAFTA and the Uruguay Round would mean that tariff-induced manufacturing would shrink in Canada. Interestingly, the Heckscher-Ohlin theory also supports the view that freer trade would return Canada to our historical dependence on exporting natural resources.

However, supply capabilities and comparative advantage evolve over time and consumer demand may change as well. For instance, as economic growth allows developing countries to catch-up to the real per capita income levels of advanced countries, consumer tastes across such countries for goods and services may converge.

Intra-industry trade. Economic progress, in boosting the convergence of real consumer incomes, also generates **demand for product variety and quality**. For example, North Americans import a variety of cars from Asia, while Asians buy different varieties of cars manufactured in North America. Consequently, trade in the same overall product category (or within the same industry classification, i.e., **intra-industry trade**) grows as real incomes converge internationally.

Economic growth in an initially resource-based economy leads to intra-industry trade in manufactured goods in a number of phases.

- First, the growth in real per capita income from exports of resources generates demand for products enjoyed by consumers in other advanced countries. To service these imported products a parts-manufacturing and servicing industry also develops in the resource abundant country.