M.A. & B.A., Economics
International Economics

Theory of Reciprocal Demand

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As we know that the share of a country from the gain in international trade depends on the terms of trade. The terms of trade at which the foreign trade would take place is determined by reciprocal demand of each country for the product of the other countries. The theory of reciprocal demand was put forward by JS. Mill and is thought to be still valid and true even today. By reciprocal demand we mean the relative strength and elasticity of the demand of the two trading countries for each other's product.

Let us take two countries A and B which on the basis of their comparative costs specialise in the production of cloth and wheat respectively. Obviously, country A would export cloth to country B, and in exchange B import wheat from it. Reciprocal demand means the strength and elasticity of demand of country A for wheat of country B, and the intensity and elasticity of country B's demand for cloth from country A. If country A has inelastic demand for wheat of country B, she will be prepared to give more of cloth for a given amount of wheat. In this case terms of trade will be unfavourable to it and consequently its share of gain from trade will be relatively smaller.

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•On the contrary, if country A's demand for import of wheat is elastic, it will be willing to offer a smaller quantity of its cloth for a given quantity of the imports of wheat. In this case terms of trade would be favourable to country A and its share of gain from trade will be relatively larger. The equilibrium terms of trade would settle at a level at which its reciprocal demand, that is, quantity of its exports which it will be willing to give for a given quantity of its imports is equal to the reciprocal demand of the other country.

•We must note that the equilibrium terms of trade are determined by the intensity of reciprocal demand of the two trading countries but they will lie in between the comparative costs (i.e., domestic exchange ratios) of the two countries. This is because no country would be willing to trade at a price which is lower than at which it can produce at home. Let us return to the example of the two countries A and B which specialise in the production of two commodities cloth and wheat respectively, and exchange them with each other.

Production conditions in the two countries are given below:

Table-1: Production of one man per week

Goods	Country A	Country B
Wheat	4 Bushels	12 Bushels
cloth	12 Yards	20 Yards

It will be seen from above Table-1 that before trade production conditions in country B are such that 12 bushels of wheat would be exchanged for 20 yards of cloth, in it, that is, the domestic ex- change ratio is 12:20 (or 3:5). On the other hand, in country A production conditions are such that 4 bushels of wheat would be exchanged for 12, yards of cloth, that is, the domestic exchange ratio is 4:12 or 1:3. Obviously, after trade, terms of trade will be settled within these domestic exchange ratios of the two countries.

The domestic exchange ratios of the two countries set the limits beyond which terms of trade would not settle after trade. It is evident that country B will be unwill- ingto offer more than 12 bushels of wheat for 20 yards of cloth since by sacrificing 12 bushels of wheat it can produce 20 yards of cloth at home.

Likewise, country A would not accept less than 6.66 bushels of wheat for 20 yards of cloth, for this is the domestic exchange rate cloth of wheat for(l:3) determined by production or cost conditions at home in country A.

It is within these limits that terms of trade will be settled between the two countries as determined by the strength of reciprocal demand of the trading countries. It also follows that it is not mere demand but also the comparative produc- tioncosts (i.e., the supply conditions) that go to determine the terms of trade. Indeed, the law of reciprocal demand, if properly understood, considers both the forces of demand and supply as deter- minantsof the terms of trade.

Critical Evaluation of the Reciprocal Demand Theory

The reciprocal demand theory of the terms of trade is based upon two countries, two commodi- tiesmodel. It assumes that full-employment conditions prevail in the economy and also that there is perfect competition in both the product and factor markets in the economies of the various countries.

It also assumes the governments of the various countries follow free trade policy and impose no restrictions on foreign trade by imposing tariffs or adopting other means to restrict imports. Further, this theory grants that there is free mobility of factors domestically within the economies of the two countries. To the extent these assumptions do not hold in the real world, the terms of trade would not conform to those determined by the reciprocal demand.

However, as stated above; every theory makes some simplifying assumptions. The soundness of a theory depends upon whether the deduc- tivelogic it employs is flawless and the conclusions it draws about the impact of economic forces on the subject investigated are correct or not. On this test the reciprocal demand theory fares very well as reciprocal demand is undoubtedly an important factor which influences terms of trade.

F.D. Graham criticized this theory by pointing out that it is applicable only to trade in antiques and old masters which are found in fixed supplies and therefore in their case demand plays a crucial role in the determination of terms of trade.

He stressed that the theory of reciprocal demand was not relevant in case of goods produced currently since their international values (i.e., terms of trade) were determined by comparative production costs (i.e., the supply conditions). In his view, recipro- caldemand theory grossly exaggerates the role of reciprocal demand and neglects the importance of comparative cost conditions.

However, Graham’s criticism is not valid. The reciprocal demand or offer curve embodies both demand and production costs. In reply to Graham’s criticism, Viner writes that “The terms of trade can be directly influenced by the reciprocal demands and by nothing else. The reciprocal demands in turn are ultimately determined by the cost conditions together with the basic utility function.”

We, therefore, conclude that terms of trade are determined by reciprocal demands of the trading countries. Reciprocal demands in turn are governed by both the demand and supply (cost) condi- tions. Thus, the intensity of demand by others for exports of a country and the intensity of its demand for imports from the other country are the important factors that determine the terms of trade. Be- sides, comparative cost conditions of the products exported and those imported have also an impor- tantrole in the determination of terms of trade.