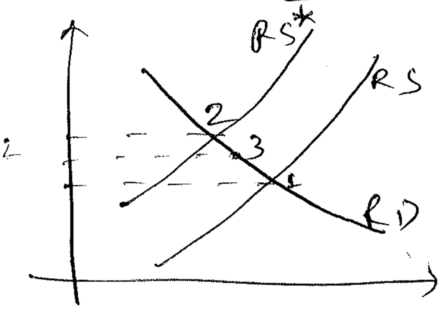
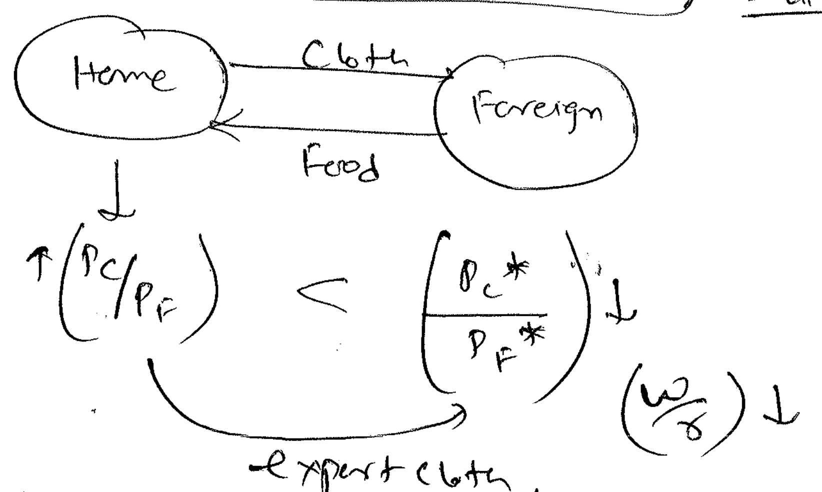
Factor-Price Equalization theorem → Samuelson





$$\left(\frac{P_C}{P_F}\right)\uparrow \longrightarrow \left(\frac{w}{r}\right)\uparrow$$

According to factor price equalization, free trade ~~f~~ leads to convergence of ~~f~~ relative price of factors of production along with convergence of relative price of goods. ~~In~~

In the absence of trade, P_C/P_F in home country is less than in foreign country. It also means that $\left(\frac{w}{r}\right)$ in home country is less than $\left(\frac{w}{r}\right)$ in foreign country. However when home & foreign country trades freely then relative price of goods convergence, which causes convergence of relative factor price also.

To understand how factor price equalization occur, we must realize that when home & foreign country trade goods with each other, then along with exchange of goods, there is indirect exchange of factors of production. Home country allow foreign country to use some of its abundant factor (that is labour) not by selling labour but by trading goods produced with higher ratio of labour to capital. Through this indirect way of trading, factor prices get equalize.

When P_C/P_F increases in home country after trade, then producers in home country prefers to produce more of cloth but to produce more of cloth, they requires