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TOPIC :- DOCTRINE OF RECIPROCAL DEMAND

Theory of Reciprocal Demand was propounded by Prof. J.S. Mill to explain the determination of equilibrium rate of exchange. According to Prof. Mill, equilibrium terms of trade are determined by the conditions of reciprocal demand. He defined terms of trade as barter terms of trade which refers to the ratio of the quantity of imports received for a given amount of exports. He focussed that the actual barter terms of trade depend not on cost conditions alone but fundamentally on demand conditions also.

Prof. Mill made argument that the actual ratio at which goods exchange between two countries will depend upon reciprocal demand. Reciprocal demand means the relative strength and elasticity of demand of the two trading countries for each other's product in terms of their own product. A stable ratio of exchange will be fixed at a point at which the value of imports and exports of each country is in equilibrium. In terms of trade, however, may be favourable to one country and unfavourable to another, depending upon the relative elasticity of demand in the country concerned, which determines the country's relative share of total gain from trade. Naturally, a country with an inelastic demand will be prepared to give more of its commodity for a certain amount of other goods when a shortage in supply occurs. The terms of trade will, thus, be unfavourable to that country and consequently its gain from trade will be less. Similarly, if a country's import demand is relatively elastic, it will offer less of its goods for a certain amount of imports. In that case, it will have favourable terms of trade and its share of gain will be larger. In other words, when a country can push the terms of trade towards the other country's domestic cost ratio, its own gain increases.

Under the analysis of the theorem of reciprocal demand, that country gains most from international trade whose exports are most in demand and which itself has little demand for things it imports. And that country gains least which has the most insistent demand for products of other countries. Hence, how much a country gains from trade depends upon the size and elasticity of demand of other countries for its commodities, compared to its own demand for their products that is, reciprocal demand elasticity which may be defined as the ratio of proportional change in the quantity of imports demanded to the proportional change in the price of exports relative to the price of imports.

Prof. Mill's theory of reciprocal demand can be analysed by offer curve analysis. The offer curve of a country

is based on the relative prices of two commodities. The offer curves represent the elasticity of reciprocal demand.
Hence,

Elasticity of Reciprocal Demand

$$= \frac{\text{Percentage change in imports}}{\left(\dfrac{\text{Percentage change in price of exports}}{\text{Percentage change in price of imports}}\right)}$$

However, it goes without saying that a shift in the terms of trade takes place when there is a change or shift in the offer curve of any country. Thus, reciprocal elasticity of demand are significant in the determination of trade and the distribution of gains from trade.

Assumptions of Reciprocal Demand Theory:-

Following are the assumptions of reciprocal demand theory:-

(I) Full employment condition.
(II) Perfect competition.
(III) Free foreign trade.
(IV) Free mobility of factors.
(V) Principle of comparative costs and specialisation.
(VI) Two-country, two-commodity model.