International Trade Theories

Objectives

- To understand theories of why countries should trade
- To comprehend how global efficiency can be increased through free trade
- To become familiar with factors affecting countries' trade patterns
- To realize why countries' export capabilities are dynamic
- To discern why the production factors of labor and capital move internationally
- To grasp the relationship between foreign trade and international factor mobility

Why we need to discuss trade theories
As management students ?

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Trade theory helps managers and government policymakers focus on three critical questions:

- What products should be imported and exported?
- How much should be traded?
- With whom should they trade?

Why Do NationsTrade?

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- A nation trades because it expects to gain something from its trading partner

- Whenever a buyer and a seller come together, each expects to gain something from the other. The same expectation applies to nations that trade with each other.

- It is virtually impossible for a country to be completely self-sufficient without incurring undue costs.

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- International trade allows a country
  - to specialize in the manufacture and export of products and services that it can produce efficiently
  - import products and services that can be produced more efficiently in other countries
  - limits on imports may be beneficial to producers, but not beneficial for consumers

Major Cause For Trade And Investment Flow

Difference in Factor Endowments: The skewed distribution of factors of resources i.e. production capabilities, possibilities and scales differ across the nations eventually forced the nation to trade among each other

Cost Advantage: Trade and investment flows are goaded by cost advantage. Cost leadership is what international firms aim at in a world of thinning down margins.

Patterns of Specialization: Trade and investment flows are triggered by patterns of specialization. Countries specialize. For example, Germany, Japan, UK and USA are good manufacturing machine tools and equipment, Singapore and India are good in IT and IT enabled services, USA and France are good in Aircrafts, Switzerland, India are good in pharmaceutical goods etc. this Specialization spells need for trade flows.

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Profit from Exchange: Trade and investment flows are motivated by profit from exchange. Milton Friedman would say the sole purpose of businesses is making profit by serving the society. Profit sources are many; one is international exchange. Export sales guarantee more profit per unit sale than comparable domestic sale.

Diversification of Sources & Markets for Physical & Financial Products and Risk: Trade and investment flows are propelled by the need for diversification of sourcing and markets both for physical and financial products. Multiple sources and markets both for inputs and outputs and both for physical and financial are essential to ward off uncertainties of supply chain and consumer patronage.

Exploitation of Natural Resources: Investment and trade flows are driven by profit-seeking transnational corporations that are interested in the exploitation of natural resources. This pattern of trade and investment leads to a high growth, though that is subject to the vicissitudes of terms-of-trade and risk-return aspects of foreign investments.

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- **Policy "U" turn Towards Mercerization by Many Economies**: Since the later part of the 20th century, change from the 'inward-looking import-substitution oriented development framework' to the 'outward-looking export-led growth oriented development and privatization have led to significant dependence on trade and investment inflows as trusted ways to economic development.
- **Common Market / Currency / Economy**: At the sub-regional level, the policy of Common Market / Currency / Economy has facilitated intra-regional trade and investment.
- **Bilateral Trade/Investment and Economic Relationship**: which help to open new paradigm that relies on mutual understanding and growth result.

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Enabling Multilateralism along with Regional Pluralism: Finally, multilateralism in the form of GATT & WTO and World Bank & Multilateral Investment Guarantee Agency (MIGA) besides others, co-existing with regional pluralism in the form of regional trade blocks and agreements between trade blocks

International trade theories

What Is Mercantilism?

Mercantilism (mid-16th century in Poland) suggests that it is in a country's best interest to maintain a trade surplus -to export more than it imports

- advocates government intervention to achieve a surplus in the balance of trade

- Mercantilism views trade as a zero-sum game
  - one in which a gain by one country results in a loss by another.
  - The primary objective of Mercantilism was to increase the power of the nation state wealth which measured by its holdings of treasure (usually gold)

Do you think mercantilism theory lead to the starting of colonialism?

Con,…d

European countries competed for world power and needed colonies to provide necessary raw materials so mother country does not have to import from other nations) and markets for exports

Theory of Neo-Mercantilism

- Mercantilism is still in vogue. Mercantilist policies are politically attractive to some firms and their workers, as mercantilism benefits certain members of society. Modern supporters of these policies are known as neo-mercantilists, or protectionists.

Protectionism" is often seen as a primary characteristic of Mercantilism

Do you think it benefit nation or…................. ?

What do you think?

What Is Smith's Theory Of Absolute Advantage?

- Adam Smith (1776) argued that a country has an absolute advantage in the production of a product when it is more efficient than any other country in producing it and enhance global efficiency through participation in free trade

Smith reasoned that:

- workers become more skilled by repeating the same tasks
- workers do not lose time in switching from the production of one kind of product to another
- longer production runs provide greater incentives for the development of more effective working methods

- The neo-mercantilists want higher production through full employment and that every industry produces an exportable surplus leading to favorable BOT.

Natural vs. Acquired Advantages

- A *natural advantage* may exist because of:
  - -given climatic conditions
  - -access to particular resources
  - -the availability of labor, etc.

- An *acquired advantage* may exist because of:
  - -superior skills
  - -better technology
  - -greater capital assets, etc.

...l income depends on the output of products as compared to the resources used to produce them.

Theory of Comparative Advantage

Comparative advantage [David Ricardo, 1817]:

A country can (I) maximize its own economic well-being by *specializing* in the production of those goods and services it can produce *relatively* efficiently and (ii) enhance global efficiency via its participation in free trade.

Ricardo also reasoned that:

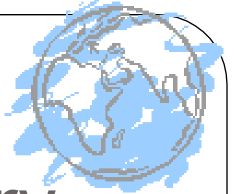
- a country can simultaneously have an *absolute* and a *comparative advantage* in the production of a given product
- by concentrating on the production of the product in which it has the greater advantage, a country can further enhance both global output and its own economic well-being
- Trade is a positive sum game

Assumptions and Limitations of the Free Trade Theories

The theories of absolute and comparative advantage both make assumptions that may not be entirely valid.

- Full employment of resources
- Exclusive pursuit of economic efficiency objectives
- Equitable division of gains from specialization
- Only two countries and two commodities
- Exclusion of transport costs
- A static rather than a dynamic view
- Exclusion of services
- Unrestricted factor mobility

Theories Explaining Patterns of Trade: Country Size, Factor Proportions, Country Similarity



The theories of country size, factor proportions, and country similarity all contribute to the explanations of:

- what types of products are traded
- with which partner nations countries will primarily trade

Non-tradable products are those goods and services that are impractical to export.

Theory of Country Size

Large countries differ from small countries in at least two critical ways:

- Large countries tend to export a smaller portion of their output and import a small portion of their consumption.

  Large countries are more apt to have varied climates and a greater assortment of natural resources than smaller countries, thus making large countries more self-sufficient.

- Large countries tend to have higher transportation costs for exported and imported products.

Given the same types of terrain and modes of transportation, the greater the distance, the higher the associated transport costs. Thus, firms in large countries often face higher transport costs in terms of sourcing inputs from and delivering outputs to distant foreign markets than do their closer foreign competitors.

What Is The Heckscher-Ohlin Theory?

- Also called factor proportion theory
- Eli Heckscher (1919) and Bertil Ohlin (1933) - comparative advantage arises from differences in national factor endowments
  - the more abundant a factor, the lower its cost
  - Heckscher and Ohlin predict that countries will export goods that make intensive use of locally abundant factors and import goods that make intensive use of factors that are locally scarce

- Does The Heckscher-Ohlin Theory Hold?

- Wassily Leontief (1953) theorized that since the U.S. was relatively abundant in capital compared to other nations, the U.S. would be an exporter of capital intensive goods and an importer of labor-intensive goods.
  - However, he found that U.S. exports were less capital intensive than U.S. imports
- Since this result was at variance with the predictions of trade theory, it became known as the Leontief Paradox

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- Because of this new theories were came to
  - Human Skills Theory
  - Product Life Cycle Theory
  - Similarity of Preferences Theory

Human Skills Theory

- Donald Keesing (1966)
- Emphasizes differences in endowments and intensities of skilled and unskilled workers.
- Explains the Leontief paradox:
  Since the U.S. has highly trained, educated workers relative to other countries, U.S. exports tend to be skilled-labor intensive.

- Product Life Cycle Theory?

- The product life-cycle theory – explains ,as products mature both the location of sales and the optimal production location will change affecting the flow and direction of trade
  - proposed by Ray Vernon in the mid-1960s
- Globalization and integration of the world economy has made this theory less valid today
  - the theory is ethnocentric
  - production today is dispersed globally
  - products today are introduced in multiple markets simultaneously

Is there a difference between international product life cycle and product life cycle?

Stage of international product life cycle

- There are three stages in international product life cycle

1. New product

- The IPLC begins when a company in a developed country wants to exploit a technological breakthrough by launching a new, innovative product on its home market.
- Such a market is more likely to start in a developed nation because more high-income consumers are able to buy and are willing to experiment with new, expensive products (low price elasticity).
- Furthermore, easier access to capital markets exists to fund new product development. Production is also more likely to start locally in order to minimize risk and uncertainty: “
- Export to other industrial countries may occur at the end of this stage that allows the innovator to increase revenue and to increase the downward descent of the product’s experience curve. Other advanced nations have consumers with similar desires and incomes making exporting the easiest first step in an internationalization effort.
- Competition will comes from a few local or domestic players that produce their own unique product variations.

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MATURING PRODUCT

Exports to markets in advanced countries further increase through time making it economically possible and sometimes politically necessary to start local production.

The product's design and production process becomes increasingly stable.

Foreign direct investments (FDI) in production plants drive down unit cost because labour cost and transportation cost decrease.

Offshore production facilities are meant to serve local markets that substitute exports from the organisation's home market. Production still requires high-skilled, high paid employees. Competition from local firms jump start in these non-domestic advanced markets. Export orders will begin to come from countries with lower incomes.

3.STANDARDISED PRODUCT cont'….d

During this phase, the principal markets become saturated.

The innovator's original comparative advantage based on functional benefits has eroded.

The firm begins to focus on the reduction of process cost rather than the addition of new product features. As a result, the product and its production process become increasingly standardised and enables further economies of scale and increases the mobility of manufacturing operations. Labour can start to be replaced by capital.

To counter price competition and trade barriers or simply to meet local demand, production facilities will relocate to countries with lower incomes. As previously in advanced nations, local competitors will get access to first hand information and can start to copy and sell the product.

- The demand of the original product in the domestic country dwindles from the arrival of new technologies, and other established markets will have become increasingly price-sensitive. Whatever market is left becomes shared between competitors who are predominately foreign.
- A MNC will internally maximize "offshore" production to low-wage countries since it can move capital and technology around, but not labour. As a result, the domestic market will have to import relatively capital intensive products from low income countries. The machines that operate these plants often remain in the country where the technology was first invented.

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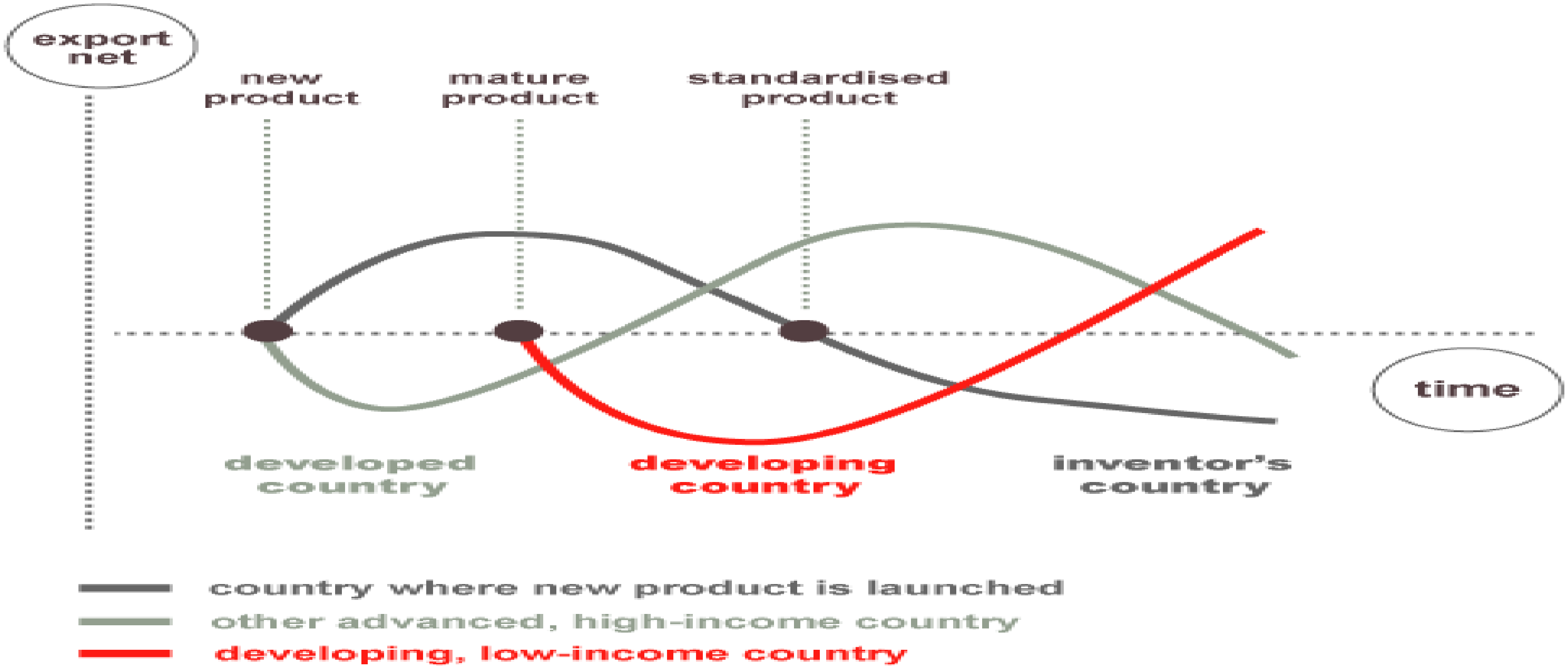
Product LifeCycle



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three stages from the initiating country's viewpoint

international product life cycle				
product stage	**trade**	**target market**	**competitors**	**production cost locally**
1 new	limited; production for home market	USA / inventor's country	few local firms	initially high
2 mature	increasing exports	USA, advanced and later developing markets	competitors from advanced markets	declining due to economies of scale
3 standardisation	declining export at first; later in phase become imports	USA / inventor's country	competitors from mostly developing markets	increase owing to lower economies of scale and comparative disadvantages

based on: Raymond Vernon , 1966. *International investment and international trade in the product cycle*. The Quarterly Journal of Economics, 80(2), pp. 190-207.

WHAt do you think the benefit ANd LIMITAtion of interNATIONAL product life cycle

Country-Similarity Theory

When a firm develops a new product in response to observed conditions in its home market, it is likely to turn to those foreign markets that are most similar to its domestic market, when commencing its initial international expansion activities.

So much trade is taking place among industrialized countries because of:

- The growing importance of acquired advantages (skills & technology).
- Markets are large enough to support new product introductions.
- Cultural similarity.
- Historical and political relationships, as well as economic agreements.

What Is New Trade Theory?

- New trade theory suggests that the ability of firms to gain economies of scale (unit cost reductions associated with a large scale of output) can have important implications for international trade
- Countries may specialize in the production and export of particular products because in certain industries, the world market can only support a limited number of firms
  - new trade theory emerged in the 1980s
  - Paul Krugman won the Nobel prize for his work in 2008

What Are The Implications Of New Trade Theory For Nations?

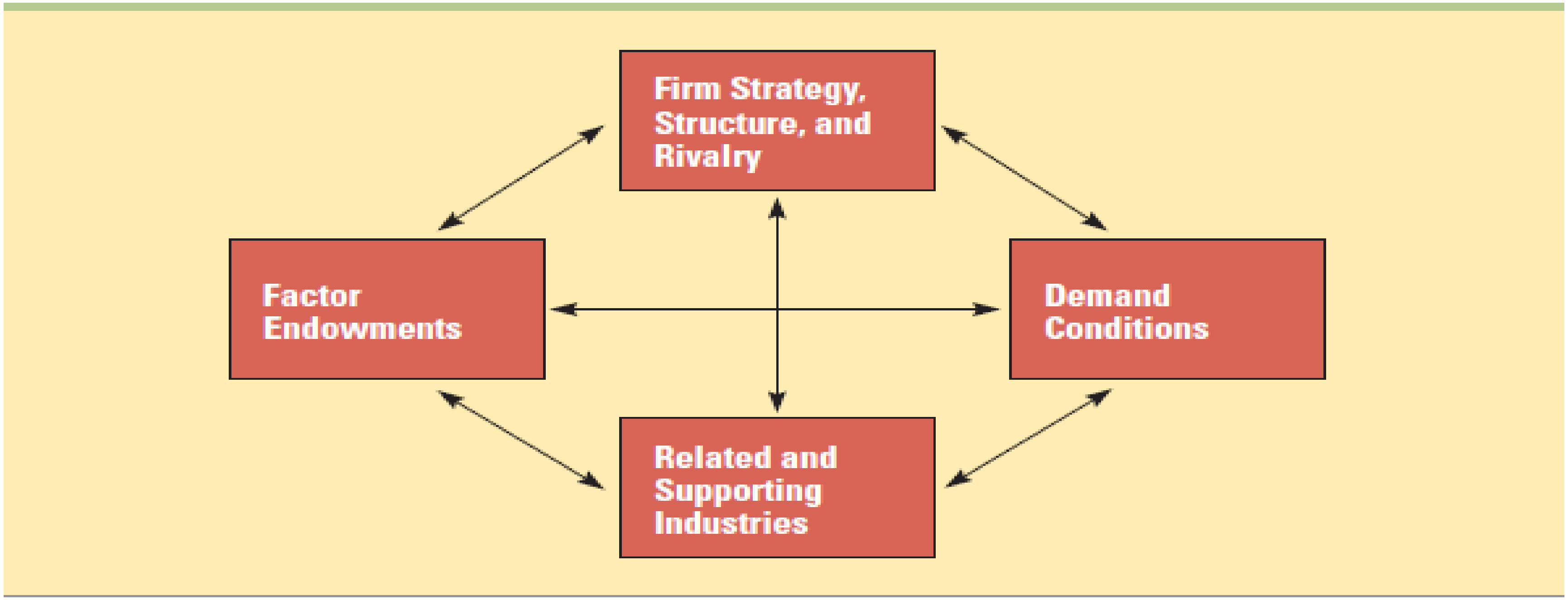
- Nations may benefit from trade even when they do not differ in resource endowments or technology
  - a country may dominate in the export of a good simply because it was lucky enough to have one or more firms among the first to produce that good
- Governments should consider strategic trade policies that nurture and protect firms and industries where first mover advantages and economies of scale are important

What Is Porter's Diamond Of Competitive Advantage?

- Michael Porter (1990) tried to explain why a nation achieves international success in a particular industry
- Porter identified four attributes that promote or impede the creation of competitive advantage
  1. Factor endowments
  2. Demand conditions
  3. Relating and supporting industries
  4. Firm strategy, structure, and rivalry

What Is Porter's Diamond Of Competitive Advantage?

Determinants of National Competitive Advantage: Porter's Diamond



Does Porter's Theory Hold?

- Government policy can
  - affect demand through product standards
  - influence rivalry through regulation and antitrust laws
  - impact the availability of highly educated workers and advanced transportation infrastructure.
- The four attributes, government policy, and chance work as a reinforcing system, complementing each other and in combination creating the conditions appropriate for competitive advantage
  - So far, Porter's theory has not been sufficiently tested to know how well it holds up

What Are The Implications Of Trade Theory For Managers?

1. Location implications - a firm should disperse its various productive activities to those countries where they can be performed most efficiently
2. First-mover implications - a first-mover advantage can help a firm dominate global trade in that product
3. Policy implications - firms should work to encourage governmental policies that support free trade

Other trade theories

- **Trade Theory of Country Size**
- **Trade Theory of Technology Gap (*JosIAH Tucker*** in the mid-1700s)
- **Trade Theory of Independence, Interdependence and Dependence**
- **Global Strategic Rivalry Theory**
- **OPPORTUNITY COST THEORY**
- **INVESTMENT THEORIES**

While descriptive theories suggest a laissez-faire treatment of trade, prescriptive theories suggest that governments should influence trade patterns.

In which side are you

Thank you