Classical theories of International Trade

International Trade Theory

- **What is international trade?**
  - Exchange of raw materials and manufactured goods (and services) across national borders
- **Classical trade theories:**
  - explain national economy conditions--country advantages--that enable such exchange to happen
- **New trade theories:**
  - explain links among natural country advantages, government action, and industry characteristics that enable such exchange to happen
- **Implications for International Business**

Classical Trade Theories

- **Mercantilism (pre-16th century)**
  - Takes an us-versus-them view of trade
  - Other country's gain is our country's loss
- **Free Trade theories**
  - Absolute Advantage (Adam Smith, 1776)
  - Comparative Advantage (David Ricardo, 1817)
  - Specialization of production and free flow of goods benefit all trading partners' economies
- **Free Trade refined**
  - Factor-proportions (Heckscher-Ohlin, 1919)
  - International product life cycle (Ray Vernon, 1966)

The New Trade Theory

- **As output expands with specialization, an industry's ability to realize economies of scale increases and unit costs decrease**

- **Because of scale economies, world demand supports only a few firms in such industries (e.g., commercial aircraft, automobiles)**

- **Countries that had an early entrant to such an industry have an advantage:**
  - **Fist-mover advantage**
  - **Barrier to entry**

New Trade Theory

- **Global Strategic Rivalry**
  - Firms gain competitive advantage trough: intellectual property, R&D, economies of scale and scope, experience

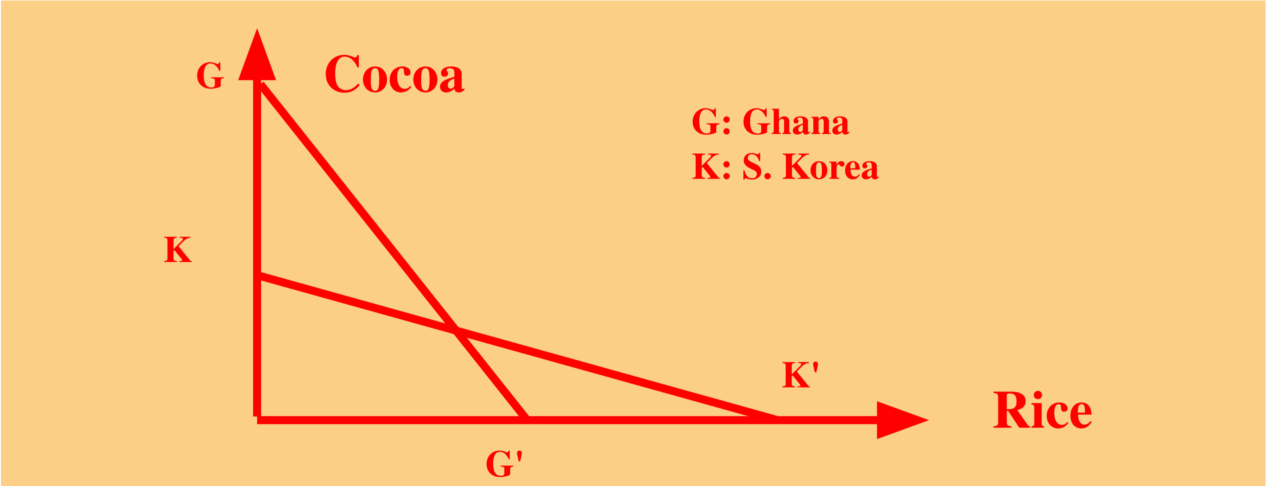
- **National Competitive Advantage (Porter, 1990)**

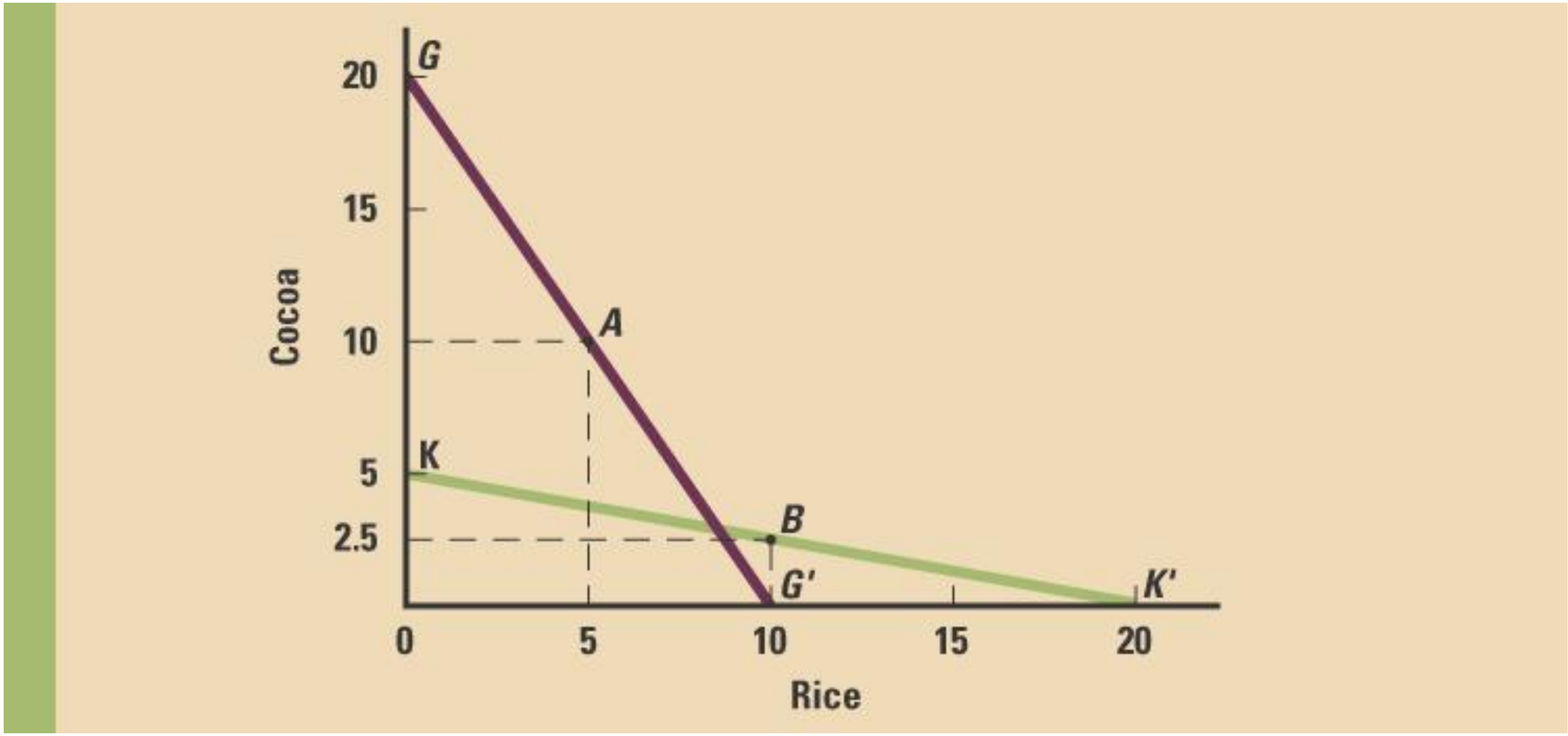
Mercantilism/Neomercantilism

- **Prevailed in 1500 - 1800**
  - Export more to "strangers" than we import to amass treasure, expand kingdom
  - Zero-sum vs positive-sum game view of trade
- **Government intervenes to achieve a surplus in exports**
  - King, exporters, domestic producers: happy
  - Subjects: unhappy because domestic goods stay expensive and of limited variety
- **Today neo-mercantilists = protectionists: some segments of society shielded short term**

Absolute Advantage

- Adam Smith: *The Wealth of Nations*, 1776
- Mercantilism weakens country in long run; enriches only a few
- A country
  - Should specialize in production of and export products for which it has absolute advantage; import other products
  - Has absolute advantage when it is more productive than another country in producing a particular product





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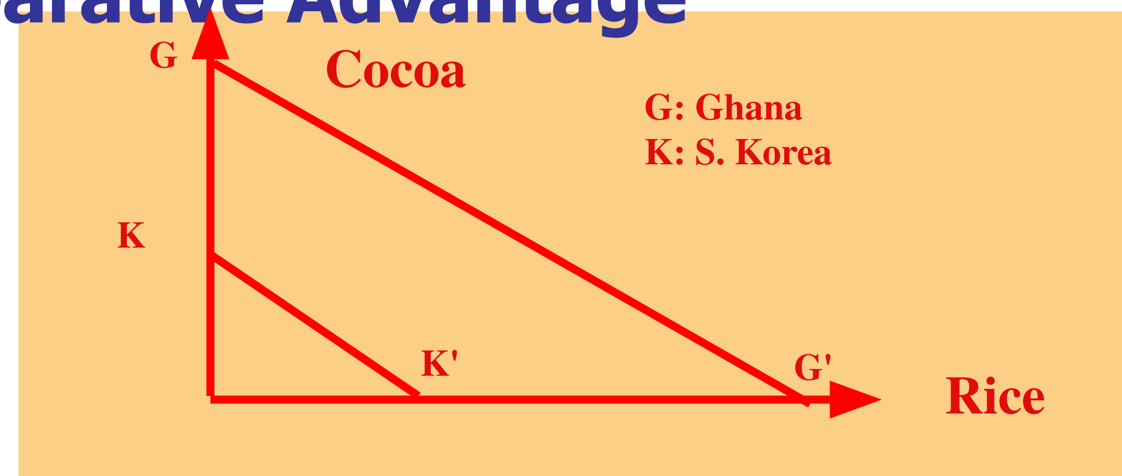
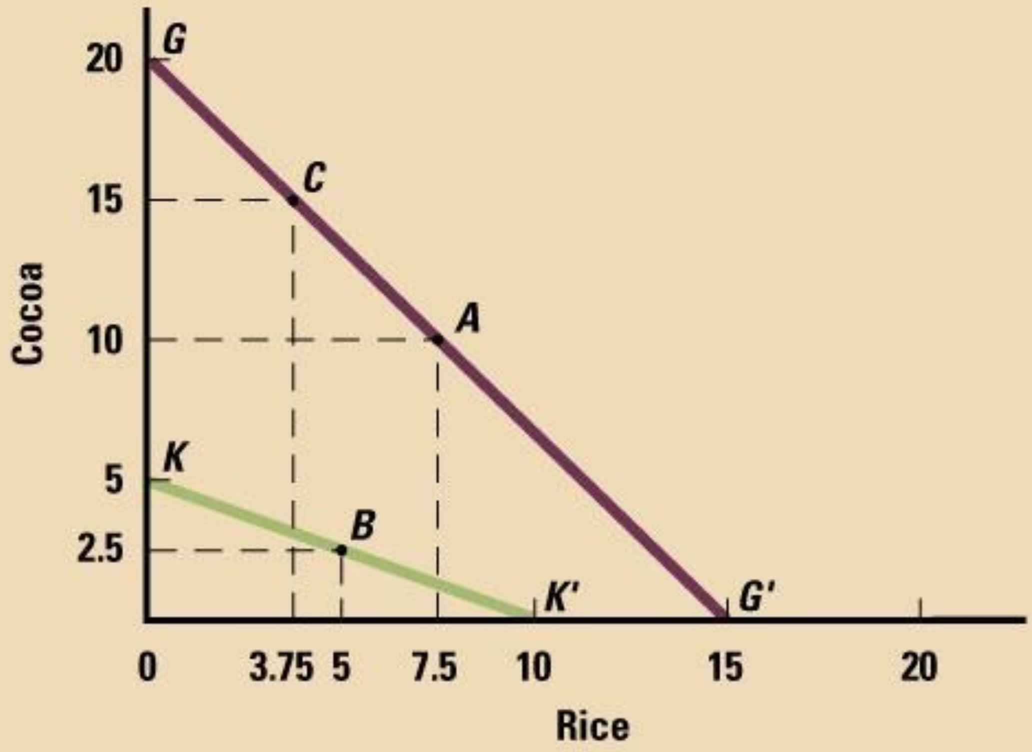
Comparative Advantage

- **David Ricardo:** ***Principles of Political Economy*, 1817**
- **Country should specialize in the production of those goods in which it is <u>relatively</u> more productive… even if it has absolute advantage in all goods it produces**
- **Absolute Advantage is a special case of Comparative Advantage**





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Heckscher (1919)-Ohlin (1933)

- **Differences in factor endowments not on differences in productivity determine patterns of trade**

- **Absolute amounts of factor endowments matter**

- **Leontief paradox:**
  - **US has relatively more abundant capital yet imports goods more capital intensive than those it exports**
  - **Explanation(?):**
    - **US has special advantage on producing new products made with innovative technologies**
    - **These may be less capital intensive till they reach mass-production state**

Theory of Relative Factor Endowments (Heckscher-Ohlin)

- **Factor endowments vary among countries**
- **Products differ according to the types of factors that they need as inputs**
- **A country has a comparative advantage in producing products that intensively use factors of production (resources) it has in abundance**
- **Factors of production: labor, capital, land, human resources, technology**

International Product Life-Cycle (Vernon)

- Most new products conceived / produced in the US in 20th century
- US firms kept production close to their market initially
    - Aid decisions; minimize risk of new product introductions
    - Demand not based on price; low product cost not an issue
- Limited initial demand in other advanced countries initially
    - Exports more attractive than overseas production
- When demand increases in advanced countries, production follows
- With demand expansion in secondary markets
    - Product becomes standardized
    - production moves to low production cost areas
    - Product now imported to US and to advanced countries

Classic Theory Conclusion

- **Free Trade expands the world "pie" for goods/services**

Theory Limitations:

- **Simple world (two countries, two products)**
- **no transportation costs**
- **no price differences in resources**
- **resources immobile across countries**
- **constant returns to scale**
- **each country has a fixed stock of resources and no efficiency gains in resource use from trade**
- **full employment**

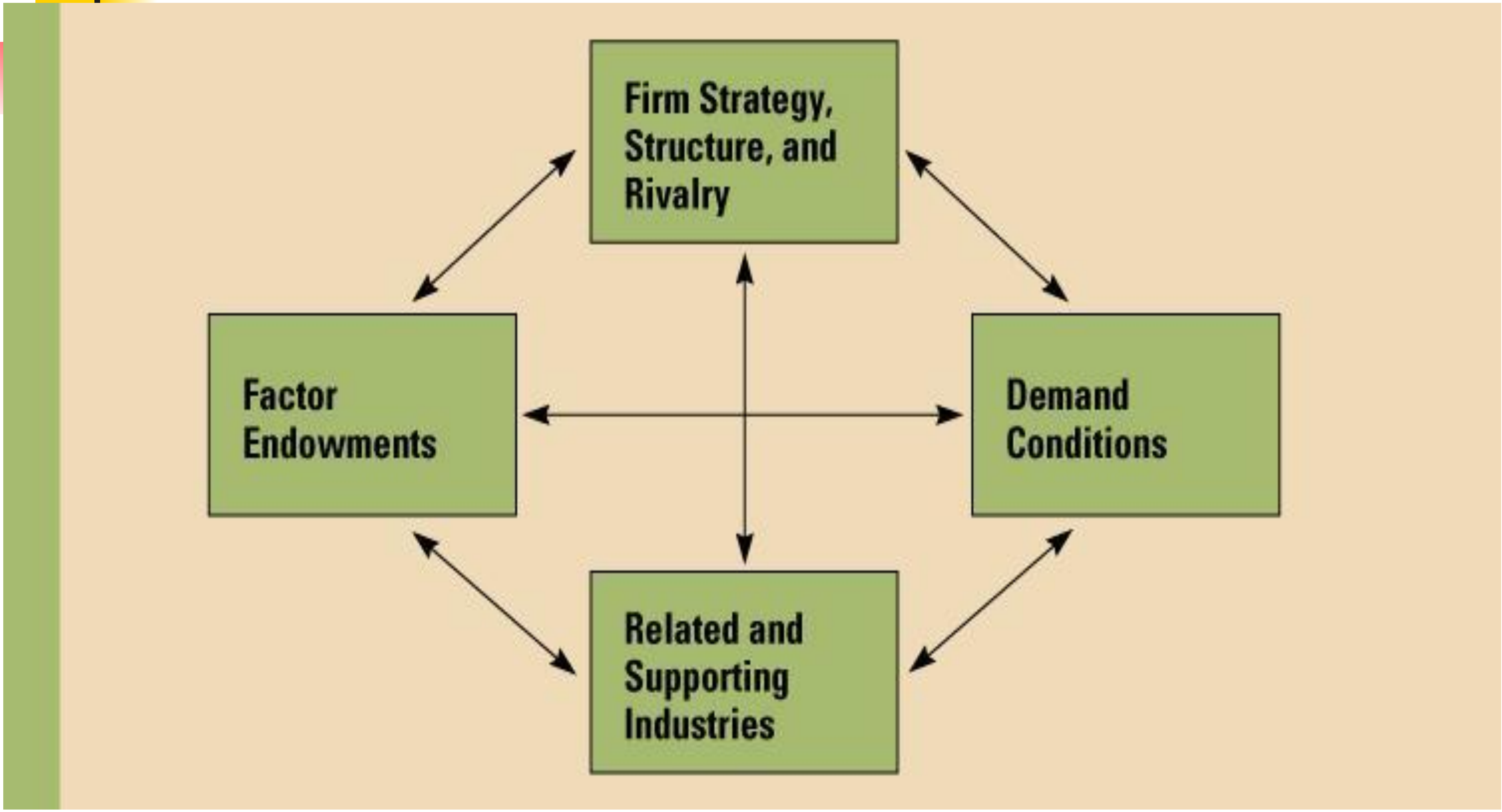
New Trade Theories

- **Increasing returns of specialization due to economies of scale (unit costs of production decrease)**
- **First mover advantages (economies of scale such that barrier to entry crated for second or third company)**
- **Luck… first mover may be simply lucky.**
- **Government intervention: strategic trade policy**

National Competitive Advantage (Porter, 1990)

- **Factor endowments**
  - **land, labor, capital, workforce, infrastructure (some factors can be created...)**
- **Demand conditions**
  - **large, sophisticated domestic consumer base: offers an innovation friendly environment and a testing ground**
- **Related and supporting industries**
  - **local suppliers cluster around producers and add to innovation**
- **Firm strategy, structure, rivalry**
  - **competition good, national governments can create conditions which facilitate and nurture such conditions**

Porter's Diamond



"So What" for business?

- **First mover implications**
- **Location Implications**
- **Foreign Investment Decisions**
- **Government Policy implications**