

# Classical theories of International Trade





# International Trade Theory

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## □ **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



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- **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



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## □ **Global Strategic Rivalry**

- Firms gain competitive advantage through:  
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

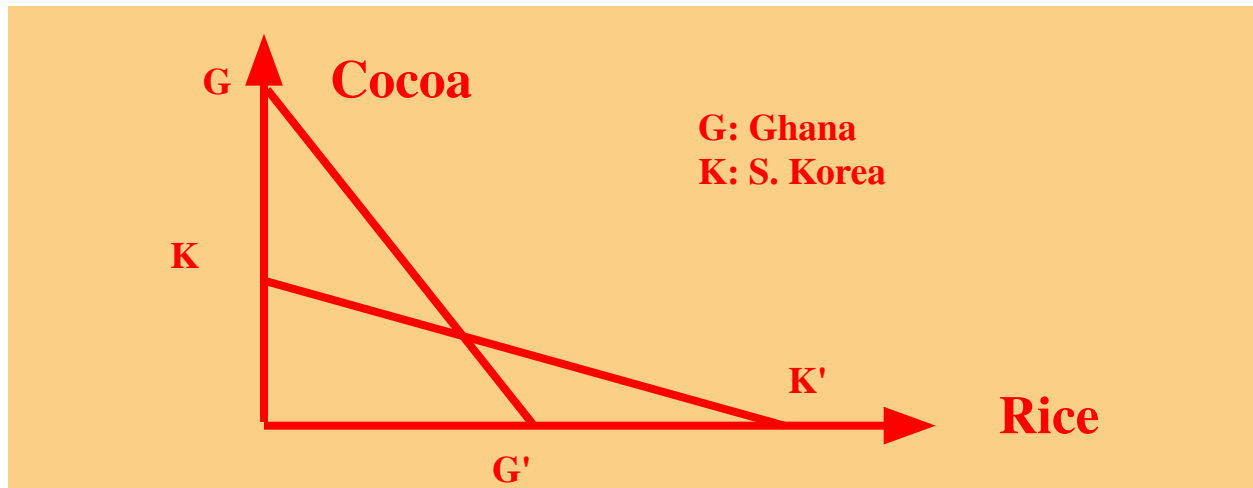
## ▣ **Government intervenes to achieve a surplus in exports**

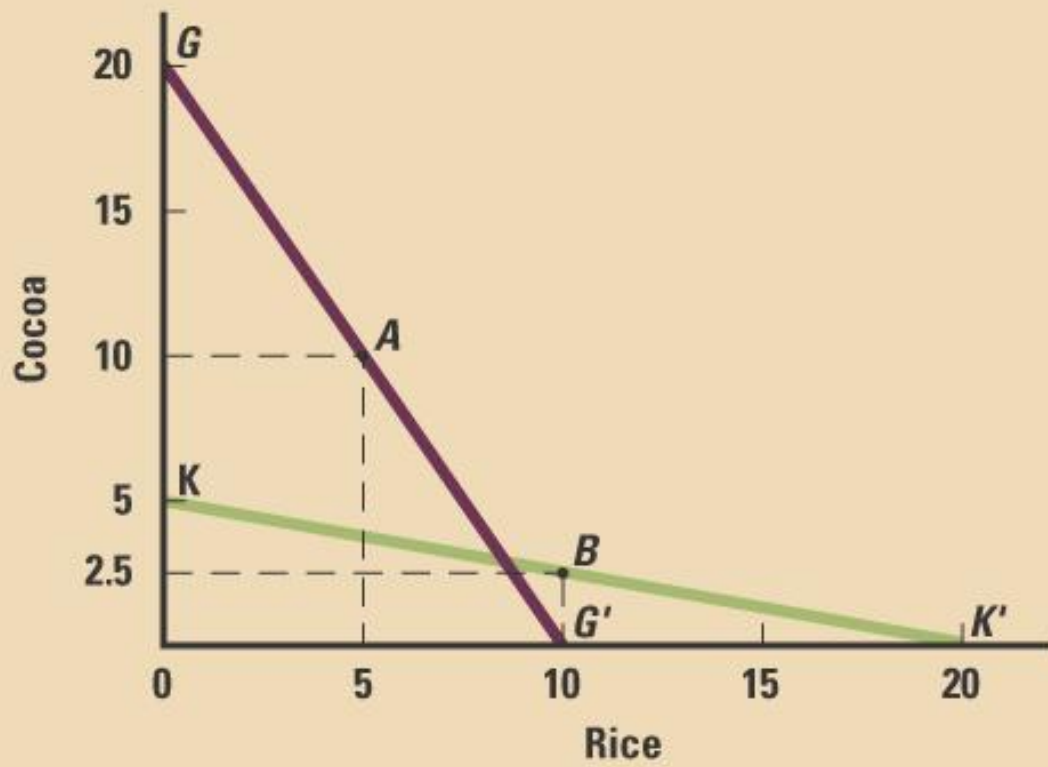
- King, exporters, domestic producers: happy
- Subjects: unhappy because domestic goods stay expensive and of limited variety

## ▣ **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

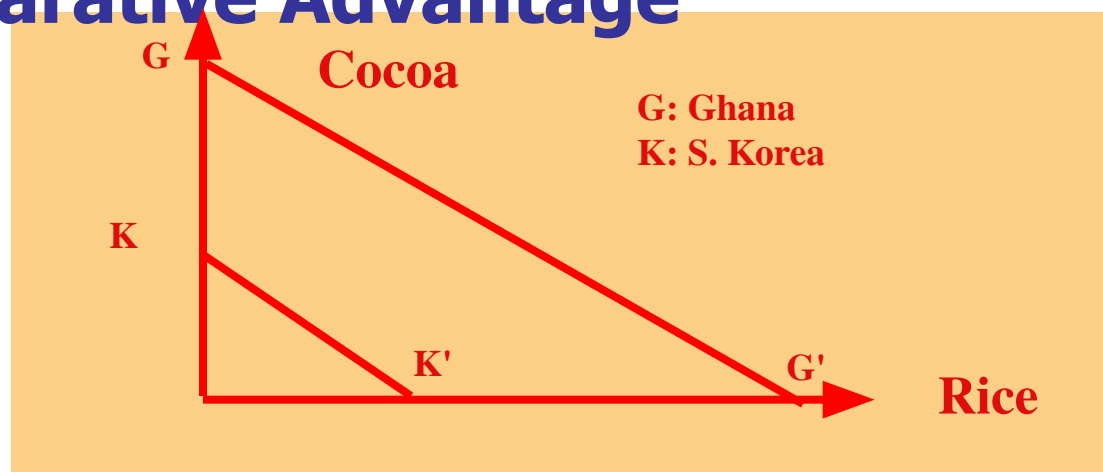


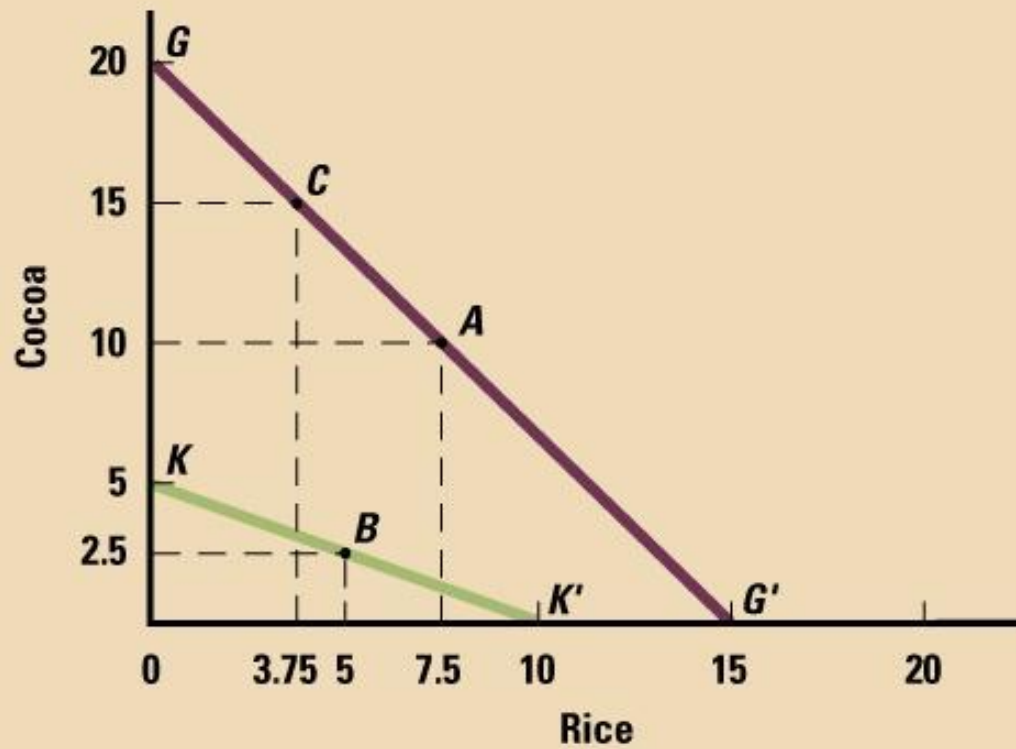




# Comparative Advantage

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







# 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)



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- **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**

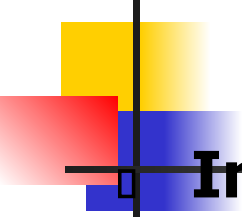
# Classic Theory Conclusion

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- **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

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- **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 created for second or third company)**
  - **Luck... first mover may be simply lucky.**
  - **Government intervention: strategic trade policy**

# National Competitive Advantage

(Porter, 1990)



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## □ **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**

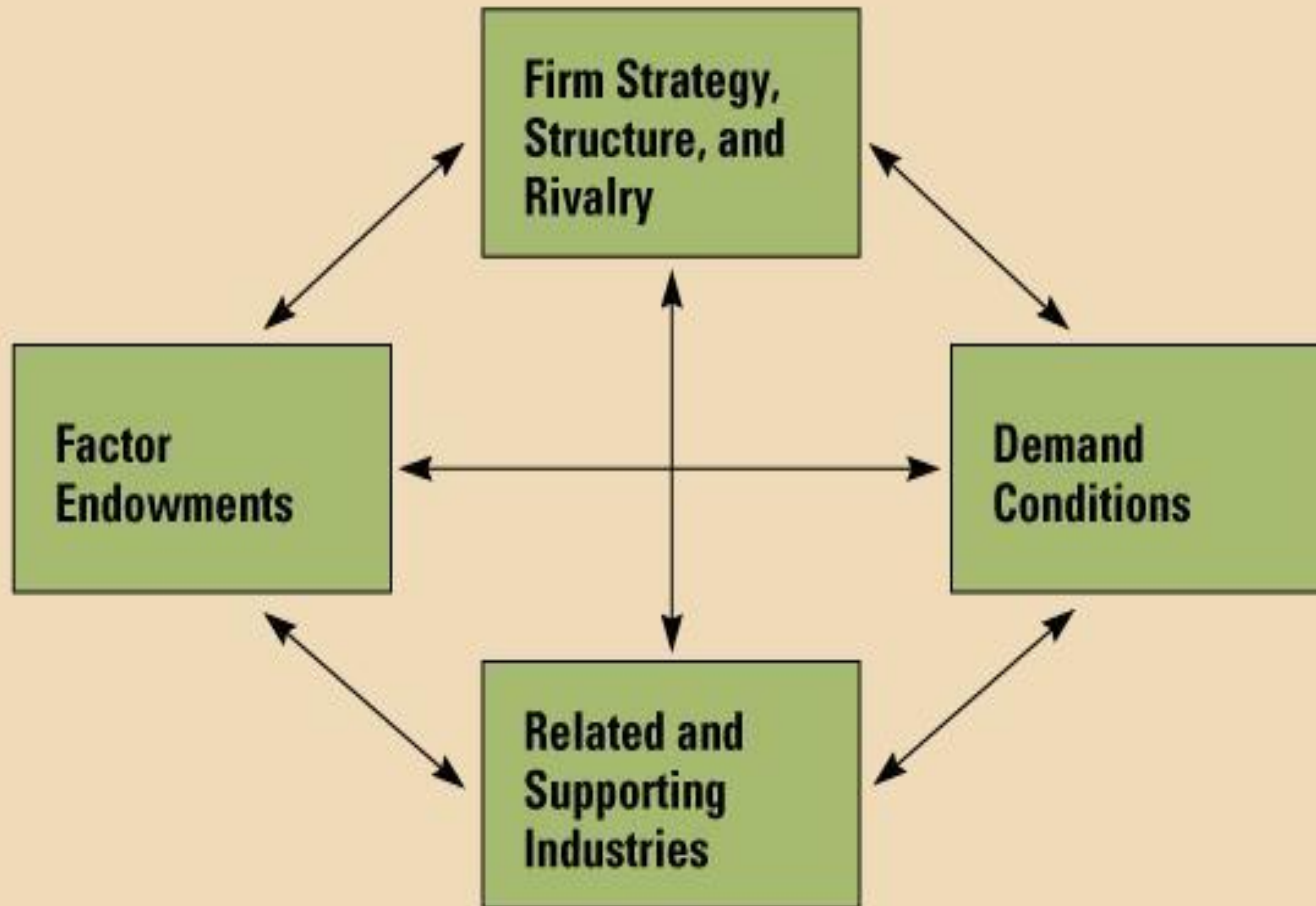
- **local suppliers cluster around producers and add to innovation**

## □ **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**

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### □ **Location Implications**

### □ **Foreign Investment Decisions**

### □ **Government Policy implications**