New Trade Theory

Lecture 8

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Trade Theories:

- Mercantilism
- Absolute Advantage
- Comparative Advantage
- Factor proportion Trade
- International Product Cycle
- **New Trade Theory**
- **National Competitive Advantage**

What Is New Trade Theory?

- In an effort to resolve some of the shortcomings of other theories, researchers in the **1970**s began to search for other explanations of trade.
- **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

New Trade Theory

- Achieving economies of scale can be very important to firms. Microsoft for example, is able to spread the costs of developing new versions of Windows over millions of PCs.
- Why is this important?
- Suppose we live in a world without trade.
- Small markets might find that they don't have certain products available if producers can't sell enough to achieve economies of scale, or if the products are available, prices will probably be very high.
- But, if countries trade with each other, markets are bigger, and firms have the opportunity to sell enough to achieve scale economies.
- Consumers have more choice and lower prices!

New Trade Theory

1. Through its impact on economies of scale, trade can increase the variety of goods available to consumers and decrease the average cost of those goods
   - without trade, nations might not be able to produce those products where economies of scale are important
   - with trade, markets are large enough to support the production necessary to achieve economies of scale
   - so, trade is mutually beneficial because it allows for the specialization of production, the realization of scale economies, and the production of a greater variety of products at lower prices

New Trade Theory

In some industries, to achieve economies of scale, firms have to have a major share of the world's market.

The costs of developing new aircraft, **for example**, are so high, that firms have to hold a significant share of the world market in order to gain economies of scale.

Remember, that there are only two makers of large commercial aircraft in the world!

2. In those industries when output required to attain economies of scale represents a significant proportion of total world demand, the global market may only be able to support a small number of enterprises
   - **first mover advantages** - the economic and strategic advantages that accrue to early entrants into an industry

New Trade Theory

- It's important to consider the effects of **first mover advantages** because the pattern of trade we see in the world economy may be the result of **first mover advantages** and **economies of scale.**
- Firms that achieve first mover advantages will develop economies of scale, and create **barriers to entry** for other firms.
- **Airbus**, for example, is currently enjoying the first mover advantages associated with its super jumbo plane.
- Airbus has to sell at least 250 super jumbos just to break even on the project.
- The market over the next twenty years is expected to be just 400 to 600 planes, so it's not worthwhile for Boeing to even get in the market.
- Airbus has first mover advantages based on scale economies.

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

National's Comperative Advantage

- **Have you ever wondered why some countries have certain industries that seem to be superior to those of other countries? Why for example, is Japan so strong in the global auto industry? Why does Switzerland dominate the pharmaceutical industry**?

- These are questions that intrigued **Michael Porter**, who in **1990**, believing that the theories at the time still left gaps in our understanding of trade patterns, tried to explain why a country might achieve international success in a particular industry.

- Porter identified four factors that he argued promoted or impeded the creation of **competitive advantage** in an industry.

- Together, he called these factors the **diamond of competitive advantage**.

National Competitive Advantage: Porter's Diamond

- **Michael Porter: *The Competitive Advantage of Nations (1990).***
- Question: "Why particular countries succeed in particular industries?"
- He studied 100 industries in 10 nations and found four broad attributes that promote or impede the creation of national competitive advantage.

What Is Porter's Diamond Of Competitive Advantage?

- Michael Porter tried to explain why a nation achieves international success in a particular industry and identified four attributes that promote or impede the creation of competitive advantage

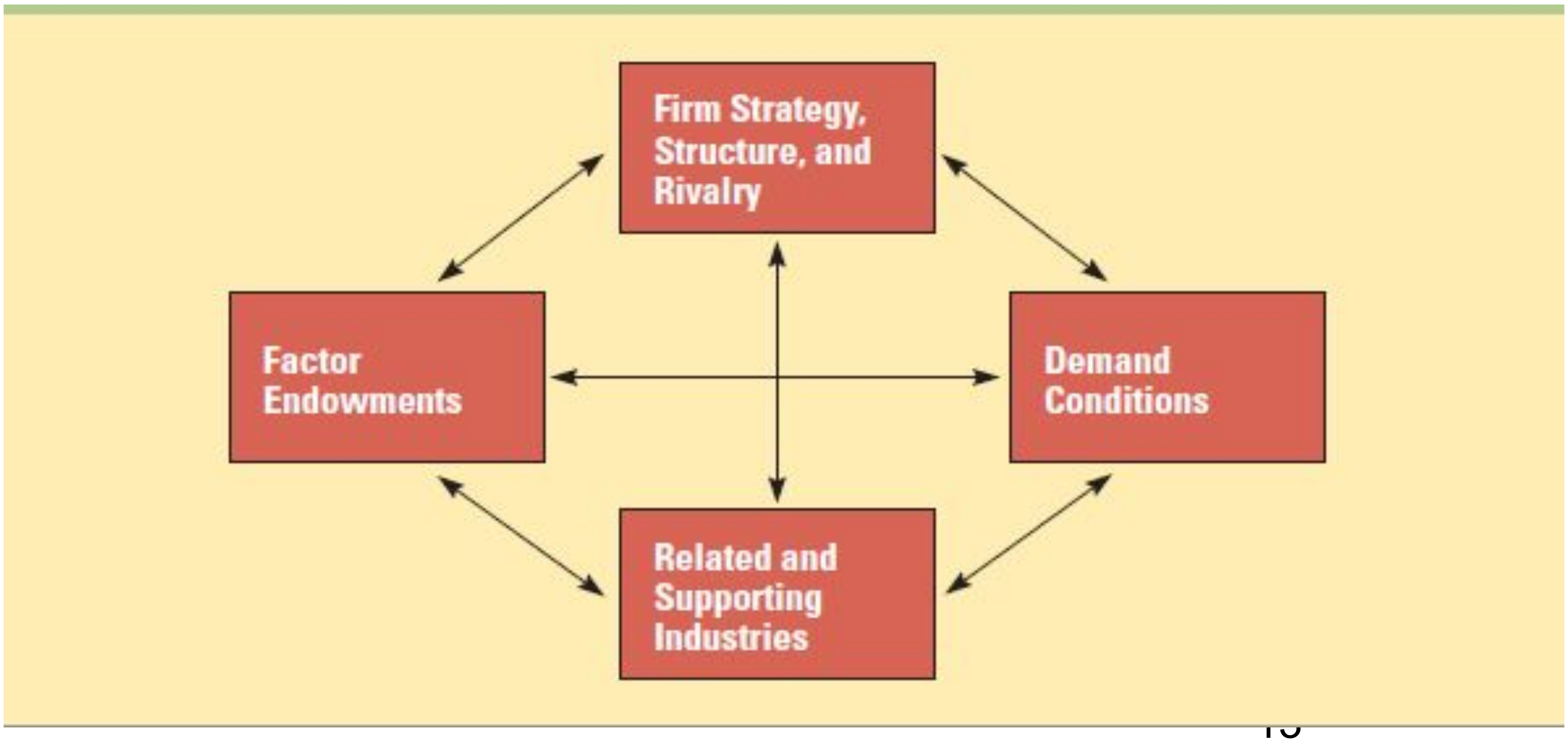
1. **Factor endowments** - a nation's position in factors of production necessary to compete in a given industry
   - can lead to competitive advantage
   - can be either basic (natural resources, climate, location) or advanced (skilled labor, infrastructure, technological know-how)
2. **Demand conditions** - the nature of home demand for the industry's product or service
   - influences the development of capabilities
   - sophisticated and demanding customers pressure firms to be competitive

What Is Porter’s Diamond Of Competitive Advantage?

3. **Relating and supporting industries** - the presence or absence of supplier industries and related industries that are internationally competitive
   - can spill over and contribute to other industries
   - successful industries tend to be grouped in clusters in countries
4. **Firm strategy, structure, and rivalry** - the conditions governing how companies are created, organized, and managed, and the nature of domestic rivalry
   - different management ideologies affect the development of national competitive advantage
   - vigorous domestic rivalry creates pressures to innovate, to improve quality, to reduce costs, and to invest in upgrading advanced features

What Is Porter's Diamond Of Competitive Advantage?

Determinants of National Competitive Advantage: Porter's Diamond



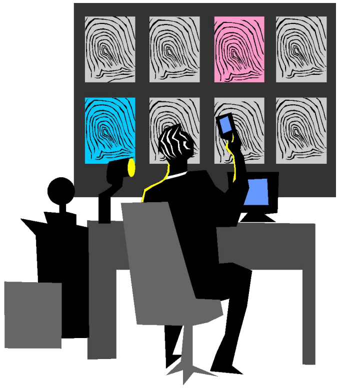
Determinants of National Competitive Advantage

Factor endowments

- **Factor endowments:** nation's position in factors of production such as skilled labor or infrastructure necessary to compete in a given industry.

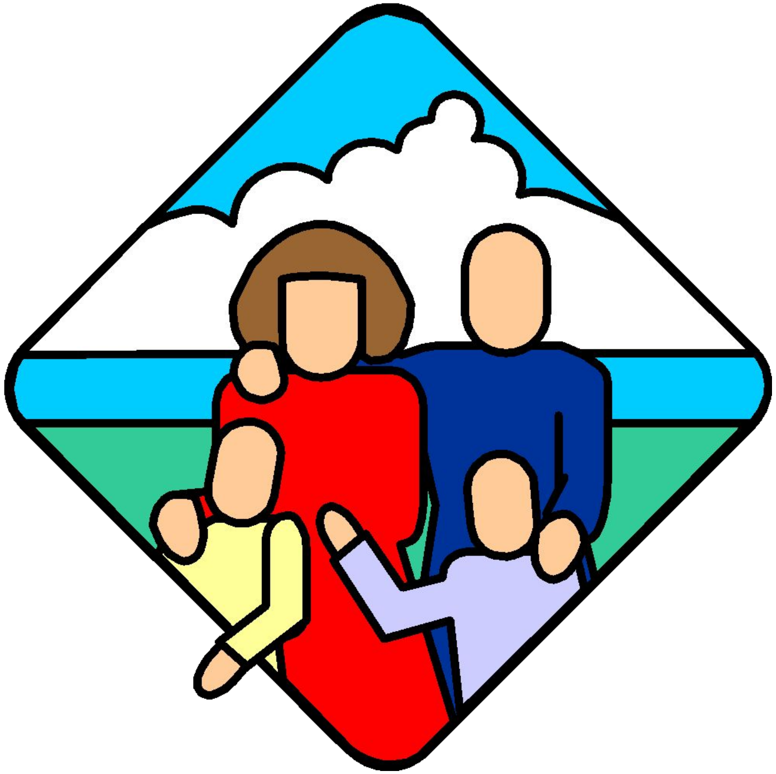
- Basic factors:
  - natural resources,
  - climate,
  - Location

- Advanced factors:
  - communications,
  - skilled labor,
  - technology.



Determinants of National Competitive Advantage
Demand conditions

- **Demand conditions:** the nature of home demand for the industry's product or service.
- Demand creates the capabilities.
- Look for sophisticated and demanding consumers.
  - impacts quality and innovation.



Determinants of National Competitive Advantage

Firm strategy, structure and rivalry

- **Firm strategy, structure and rivalry:** the conditions in the nation governing how companies are created, organized, and managed and the nature of domestic rivalry.

- Firms that face strong domestic competition will be better able to face competitors from other firms.

Determinants of National Competitive Advantage

Related and supporting industries

- **Related and supporting industries:** the presence or absence in a nation of supplier industries or related industries that are internationally competitive.
  - Creates clusters of supporting industries that are internationally competitive.
  - Cost-effective input, information, exchange of ideas and information.
  - Source of innovation and upgrading.

Overview Of Trade Theory

National Competitive Advantage: Porter's Diamond

- In addition to these four main attributes, government policies and chance can impact any of the four.
    - Government policy can affect demand through product standards, influence rivalry through regulation and antitrust laws, and impact the availability of highly educated workers and advanced transportation infrastructure.
- The four attributes of the diamond, government policy, and chance work as a reinforcing system, complementing each other and in combination creating the conditions appropriate for competitive advantage.
    - The Management Focus on Nokia provides a good example of how this Finnish firm built its competitive advantage as a result of factors in 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
   - firms that do not, may be at a competitive disadvantage

2. **First-mover implications** - Being a first mover can have important competitive implications, especially if there are economies of scale and the global industry will only support a few competitors. Firms need to be prepared to undertake huge investments and suffer losses for several years in order to reap the eventual rewards.

What Are The Implications Of Trade Theory For Managers?

3. **Policy implications** - firms should work to encourage governmental policies that support free trade

- firms should lobby the government to adopt policies that have a favorable impact on each component of the diamond

4. **Government Policy:**

- Indirect role in all of 4 diamonds
- Invest in HR, infrastructure, R&D, education
- Secure vigorous internal competition
- promoting free trade is generally in the best interests of the home-country.

What Is The Balance Of Payments?

- You may be wondering how we know what countries are exporting and importing. Well, all of that information is contained in a **country's balance of payments**.

- A country's **balance of payments accounts** keep track of the payments to and receipts from other countries for a particular time period
- Balance of payments accounting uses double entry bookkeeping
  - so, the sum of the current account balance, the capital account and the financial account should always add up to zero
- There are three main accounts:

What Is The Balance Of Payments?

1. The **current account** records transactions that pertain to goods, services, and income, receipts and payments
   - **current account deficit** - a country imports more than it exports
   - **current account surplus** – a country exports more than it imports
2. The **capital account** records one time changes in the stock of assets
3. The **financial account** records transactions that involve the purchase or sale of assets
   - net change in U.S. assets owned abroad
   - foreign owned assets in the United States

What Is The Balance Of Payments?

Current Account	$ Millions
Exports of Goods, Services and Income Receipts	2,463,505
Goods	1,148,481
Services	497,245
Income Receipts	817,779
Imports of Goods, Services and Income Payments	−3,082,014
Goods	−1,967,853
Services	−378,130
Income Payments	−736,030
Unilateral current transfers (net)	−112,705
Current Account Balance	−731,215
CAPITAL ACCOUNT	
Capital Account Transactions (net)	−1,843
FINANCIAL ACCOUNT	
U.S. Owned Assets Abroad, net	−1,289,854
U.S. Official Reserve Assets	122
U.S. Government Assets	22,273
U.S. Private Assets	−1,267,459
Foreign Owned Assets in the United States	2,057,703
Foreign Official Assets in the United States	411,058
Other Foreign Assets in the United States	1,646,645
Statistical Discrepancy	−41,287

Is A Current Account Deficit Bad?

- Does current account deficit in the United States matter?
- a current account deficit implies a net debtor
  - so, a persistent deficit could limit future economic growth
- But, even though capital is flowing out of the United States as payments to foreigners, much of it flows back in as investments in assets
- Yet, suppose foreigners stop buying U.S. assets and sell their dollars for another currency
- A dollar crisis could occur