



### Key Issues

- Why do nations trade with each-other?
- How do different theories explain trade flows?
- How does free trade raise the economic welfare of all participating nations? Any disagreements?
- Can government actively influence a country's competitive advantage?
- Why is an understanding of trade theory important for managers?

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### 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

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### Classical Country-Based Theories

- Mercantilism (pre-16th century)
  - Takes an us-versus-them view of trade; other country's gain is our country's loss
  - Neo-mercantilism views persist today
- Free Trade supporting theories
  - Show that specialization of production and free flow of goods grow all trading partners' economies
  - Absolute Advantage (Adam Smith, 1776)
  - Comparative Advantage (David Ricardo, 1817)
- Free Trade refined
  - Factor-proportions (Heckscher-Ohlin, 1919)
  - International product life cycle (Ray Vernon, 1966)

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### The New Trade Theory

- In many industries, as output expands with specialization, the ability to realize economies of scale increases and unit costs should decrease
- Because of such 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 in such an industry:
  - First-mover advantage
  - Barrier to entry (Airbus overcame through government subsidies?)

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## New Trade Theory

- Global Strategic Rivalry
  - Firms gain competitive advantage through: intellectual property, R&D, economies of scale and scope, experience
- National Competitive Advantage (Porter, 1990)

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## Mercantilism/Neomercantilism

- Prevailed from 1500 to 1800
  - Export more to “strangers” than we import to amass treasure, expand kingdom
  - Maximize exports and minimize imports: no advantage in increased 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
- Zero-sum vs positive-sum game view of trade

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## Absolute Advantage

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

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## Comparative Advantage

- David Ricardo: *Principals 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 really a special case of comparative advantage

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## Heckscher (1919)-Ohlin (1933) Theory

- The pattern of international trade depends on differences in factor endowments not on differences in productivity
- 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

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## 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

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## International Product Life-Cycle (Vernon)

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

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## Classic Theory Limitations

- Fundamentally: 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

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## New Trade Theories

- Increasing returns of specialization due to economies of scale (unit costs of prod. 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

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## 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

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## “So What” for business?

- First mover implications
  - invest to be first, particularly in global industries or in markets which can support a few firms
- Location Implication
  - if countries have comparative advantages MNEs want to locate appropriate activities in those countries...
- Foreign Investment Decisions
- Government Policy implications
  - companies generate imports and exports. Thus can influence government decisions on trade policy...

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