

INTERNATIONAL BUSINESS

Competing in the Global Marketplace



Chapter 06

International Trade Theory

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Competing in the Global Marketplace

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Learning Objectives

- 6-1** Understand why nations trade with each other.
- 6-2** Summarize the different theories explaining trade flows between nations.
- 6-3** Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.
- 6-4** Explain the arguments of those who maintain that government can play a proactive role in promoting national competitive advantage in certain industries.
- 6-5** Understand the important implications that international trade theory holds for management practice.

Introduction

Cross-Border Trade

- Dramatic growth over the past 70 years in the amount of international trade.
- Recent acceleration of value in traded services.
- Gains from trade: countries specialize in the production (and export) of goods and services that they produce most efficiently, while importing goods and services that they cannot produce so efficiently from other nations.
- Shift in policy away from free trade toward managed trade.

An Overview of Trade Theory ¹

Free Trade

Government does not attempt to influence through quotas or duties what its citizens can buy from another country or what they can produce and sell to another country.

- Adam Smith's theory of absolute advantage.
- David Ricardo's theory of comparative advantage.
- Heckscher–Ohlin theory.

An Overview of Trade Theory₂

The Gains from Trade

Trade theories explain why international trade is beneficial even for products a country can produce itself.

- Allows specialization.

Limits on imports are often in the interests of domestic producers but not domestic consumers.

An Overview of Trade Theory³

The Pattern of International Trade

Much of the observed pattern of international trade is more difficult to explain.

- Ricardo's theory of comparative advantage focuses on differences in productivity.
- Heckscher–Ohlin theory focuses on factors of production.
- Vernon's product life-cycle theory focuses on production location changes as products become more widely accepted internationally.
- Krugman's new trade theory focuses on first-mover advantages.

Competitive Advantage



Kristi Blokhin/Shutterstock

A Rolex Group logo sits on display above a luxury wristwatch store in Vienna, Austria.

An Overview of Trade Theory⁴

Trade Theory and Government Policy

- Mercantilism advocates government involvement in promoting exports and limiting imports.
- Smith, Ricardo, and Heckscher–Ohlin call for unrestricted free trade.
- New trade theory and Porter's national competitive advantage theory justify limited government intervention for certain export-oriented industries.

Mercantilism

Mercantilism

Emerged in England in the mid sixteenth century.

- Gold and silver are the mainstays of national wealth.

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.

Flaw is that it views trade as a zero-sum game:

- A gain by one country results in a loss by another.

Absolute Advantage

Adam Smith (1776), *The Wealth of Nations*

Attacked the mercantilist assumption of zero-sum game.

Promoted absolute advantage:

- Country has an absolute advantage in producing a product when it is more efficient than any other country at producing it.
- Countries should specialize in the production of goods for which they have an absolute advantage and then trade these goods for those produced by other countries.
- Both countries benefit by engaging and trading.

Figure 6.1 The Theory of Absolute Advantage



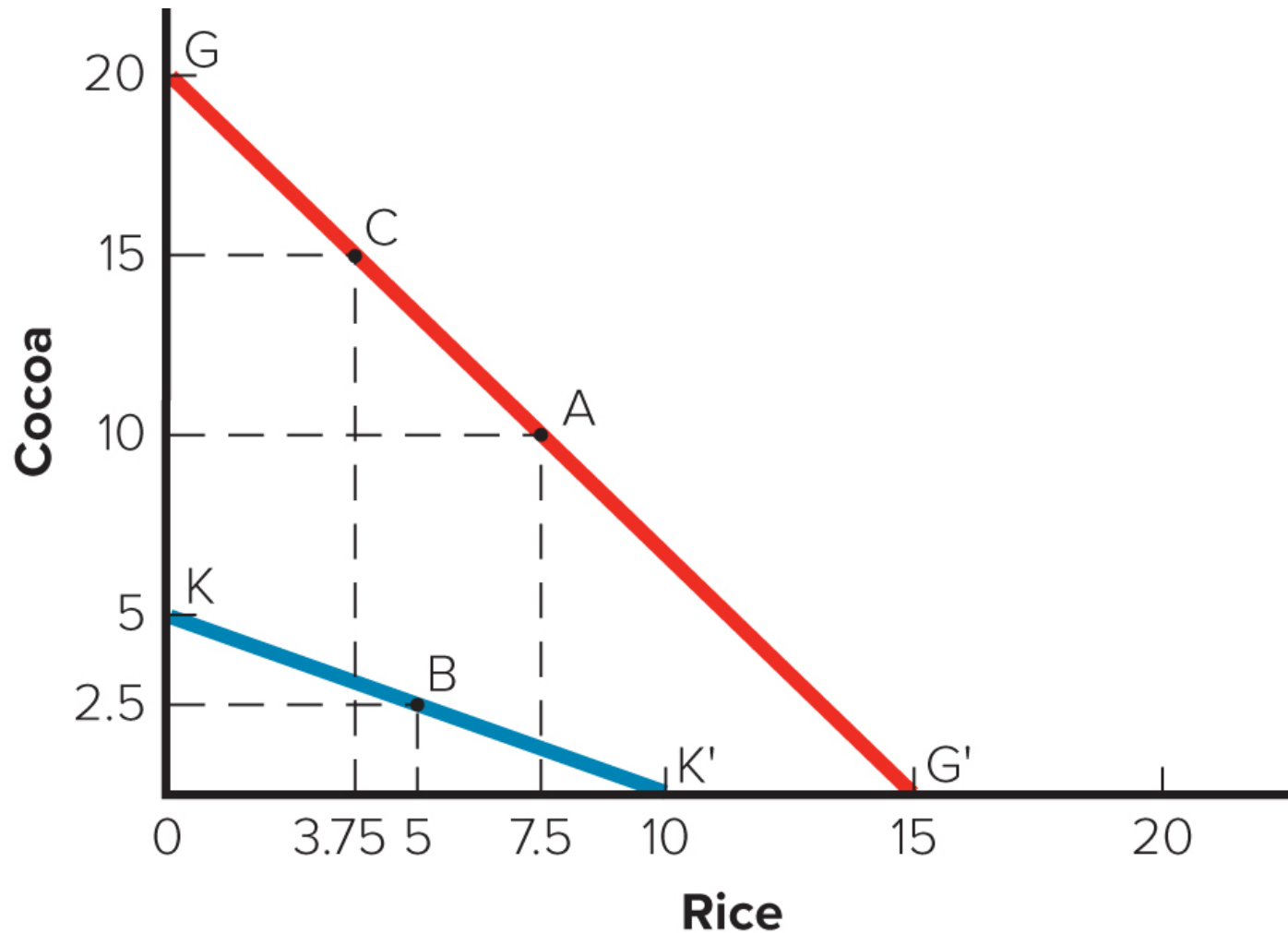
Comparative Advantage ¹

David Ricardo (1817) *Principles of Political Economy*

Promoted comparative advantage:

- A country should specialize in the production of goods it produces most efficiently and buy the goods it produces less efficiently from other countries, even if it can produce those goods more efficiently itself.

Figure 6.2 The Theory of Comparative Advantage



Comparative Advantage ₂

The Gains from Trade

- Potential world production is greater with unrestricted free trade than with restricted trade.
- The theory of comparative advantage suggests that trade is a positive-sum game in which all countries that participate realize economic gains.

Comparative Advantage₃

Qualifications and Assumptions

- Simple world with two countries and two goods.
- No transportation costs.
- No differences in price of resources.
- Resources can move freely.
- Constant returns to scale.
- Each country has a fixed stock of resources and free trade does not change the efficiency with which a country uses its resources.
- No effects of trade on income distribution within a country.

Comparative Advantage ⁴

Extensions of the Ricardian Model

Immobile resources:

- Resources do not always move easily from one economic activity to another.
- Political opposition to a free trade regime typically comes from those whose jobs are most at risk.

Comparative Advantage⁵

Extensions of the Ricardian Model

Diminishing returns:

- Comparative advantage model assumes constant returns to specialization.
- More realistic to assume diminishing returns to specialization.
 - Not all resources are the same quality.
 - Different goods use resources in different proportions.

Figure 6.3 Ghana's PPF under Diminishing Returns



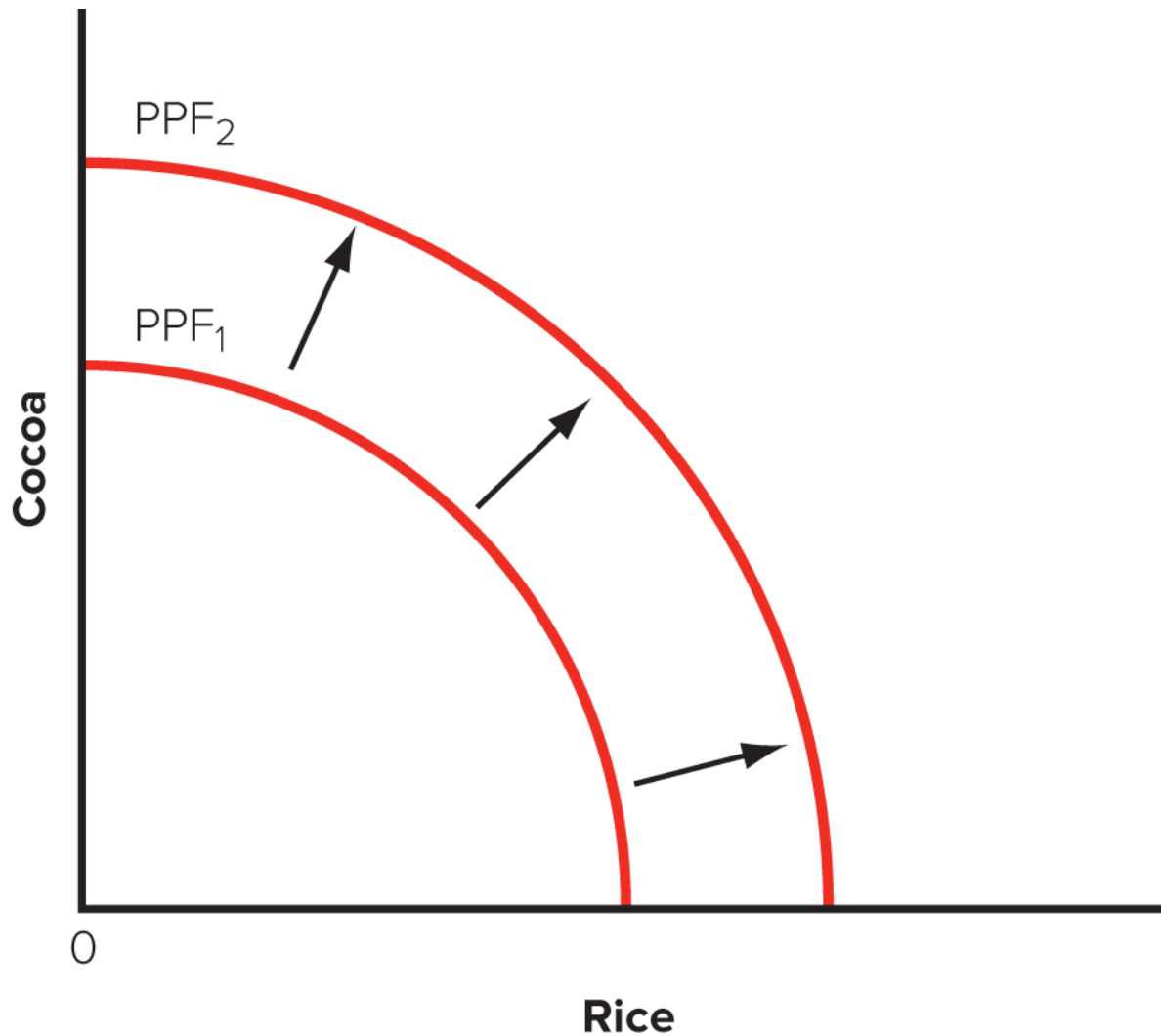
Comparative Advantage ⁶

Extensions of the Ricardian Model

Dynamic effects and economic growth:

- Free trade can result in two types of dynamic gains:
 1. Increase a country's stock of resources as increased supplies of labor and capital from abroad become available within the country.
 2. Increase the efficiency with which a country uses its resources.
- Dynamic gains in both the stock of a country's resources and the efficiency with which resources are utilized will cause a country's PPF to shift outward.

Figure 6.4 The Influence of Free Trade on the PPF



Comparative Advantage ⁷

Extensions of the Ricardian Model

Trade, jobs, and wages: The Samuelson critique.

- Paul Samuelson asks: what happens when a rich country (United States) enters into a free trade agreement with a poor country (China) that rapidly improves its productivity after the introduction of a free trade regime?
- Lower prices may not make up for lower wages in the United States.
- Concerned with offshoring service jobs.
- Historically, free trade has benefited rich countries.
- Introducing protectionist measures may be harmful to United States.

Comparative Advantage 8

Extensions of the Ricardian Model

Evidence for the link between trade and growth:

- Countries that adopt a more open stance toward international trade enjoy higher growth rates than those that close their economies to trade.
- Sachs and Warner created a measure of how “open” to international trade an economy was.
- Question about the impact of tariff barriers.

Heckscher–Ohlin Theory ¹

Factor Endowments

Comparative advantage arises from differences in national factor endowments.

- Extent to which a country is endowed with resources such as land, labor, and capital.

Countries will export goods that make intensive use of factors that are locally abundant.

Countries will import goods that make intensive use of factors that are locally scarce.

Heckscher–Ohlin Theory₂

The Leontief Paradox

- Raised questions about the validity of the Heckscher–Ohlin theory.
- Found that U.S. exports were less capital intensive than U.S. imports.

The Product Life-Cycle Theory ¹

Raymond Vernon's Product Life-Cycle Theory

For most of twentieth century, new products were developed and first sold in the United States.

- Due to the wealth and size of the U.S. market and cost-saving process innovations.

Limited initial demand necessitates some exports early in product life cycle.

Over time, demand grows in other countries, the product becomes standardized, and price becomes the main competitive weapon.

- Other countries can now produce product at lower costs, limiting the potential for U.S. exports.

The Product Life-Cycle Theory₂

Product Life-Cycle Theory in the Twenty-First Century

- Historically, an accurate theory.
- Now seems ethnocentric and increasingly dated.

New Trade Theory ¹

Economies of Scale

Cost reductions associated with large-scale production.

Can have important implications for international trade.

- Trade can increase the variety of goods available to consumers and decrease the average cost of those goods.
- The global market may support only a small number of enterprises for industries in which the output required to attain economies of scale represents a significant proportion of total world demand.

New Trade Theory ₂

Increasing Product Variety and Reducing Costs

What would happen in a world without trade?

- The variety of goods a country can produce and the scale of production are limited by the size of the market.
- Low volumes and higher costs.

What happens in a world with trade?

- Individual national markets are combined into a larger world market.
- Each nation can increase the variety of goods and lower the costs of those goods.

New Trade Theory³

Economies of Scale, First-Mover Advantages, and the Pattern of Trade

First-mover advantages:

- Economic and strategic advantages accruing to early to enter a market.
- Can gain a scale-based cost advantage; later entrants find it almost impossible to match.

New Trade Theory⁴

Implications of New Trade Theory

Nations may benefit from trade even when they do not differ in resource endowments or technology.

A country may predominate 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.

- May create a barrier to entry.

Useful in explaining trade patterns.

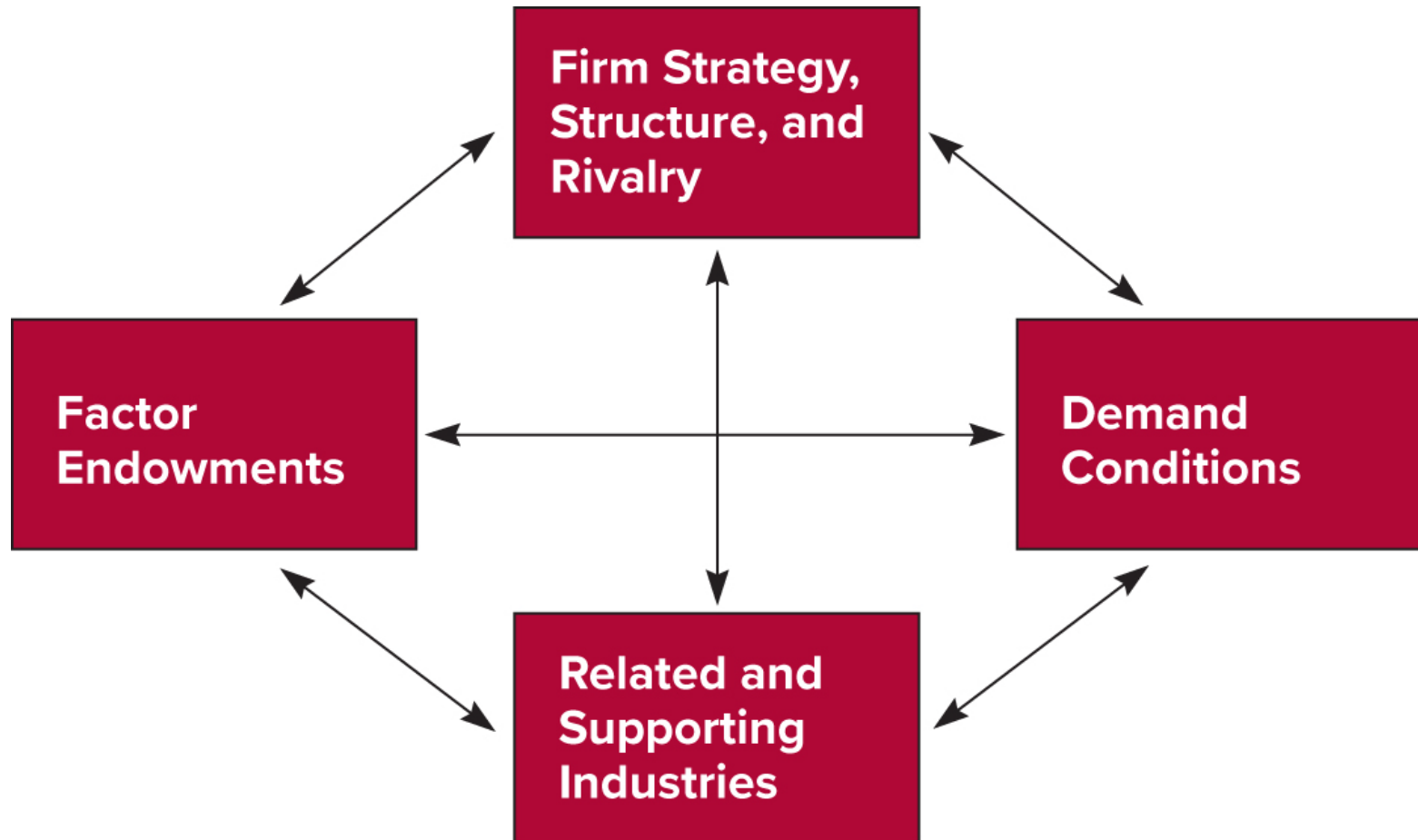
Argues for government intervention and strategic trade policy.

National Competitive Advantage: Porter's Diamond¹

Porter believed existing theories only told part of the story.

- Wanted to explain why a nation achieves international success in a particular industry.
- Four broad attributes of a nation shape the environment in which local firms compete:
 1. Factor endowments.
 2. Demand conditions.
 3. Related and supporting industries.
 4. Firm strategy, structure, and rivalry

Figure 6.5 The Determinants of National Competitive Advantage: Porter's Diamond



Source: Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990; republished with a new introduction, 1998), p. 72.

National Competitive Advantage: Porter's Diamond₂

Porter's four attributes constitute a diamond.

Firms are most likely to succeed in industries or industry segments where the diamond is most favorable.

- The diamond is a mutually reinforcing system.
- Two additional variables can influence the national diamond:
 1. Chance.
 2. Government.

National Competitive Advantage: Porter's Diamond₃

Factor Endowments

Basic factors:

- Natural resources, climate, location, and demographic.
- Can provide an initial advantage.

Advanced factors:

- Communication infrastructure, sophisticated and skilled labor, research facilities, and technological know-how.
- Are a product of investment by individuals, companies, and governments.

National Competitive Advantage: Porter's Diamond⁴

Demand Conditions

- Firms gain competitive advantage if their domestic consumers are sophisticated and demanding.

Related and Supporting Industries

- Investments in advanced factors of production by related and supporting industries can help the industry achieve a strong competitive position internationally.
- Successful industries within a country tend to be grouped into clusters of related industries.

National Competitive Advantage: Porter's Diamond⁵

Firm Strategy, Structure, and Rivalry

- Different nations are characterized by different management ideologies, which may or may not help them build national competitive advantage.
- Strong association between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry.

National Competitive Advantage: Porter's Diamond₆

Evaluating Porter's Theory

Government can influence each component—either positively or negatively.

- Factor endowments can be affected by subsidies, policies toward capital markets, policies toward education, and more.
- Can shape domestic demand through local product standards or with regulations.
- Can influence firm rivalry through capital market regulation, tax policy, and antitrust laws.

Porter's theory has not been subjected to detailed empirical testing.

360° View: Managerial Implications

Location, First-Mover Advantages, Government Policy, Investments, and strategy

Location: from a profit perspective, firms should disperse production to countries where they can be performed most efficiently.

First-mover advantages: it pays to invest substantial financial resources in building an early advantage.

Government policy: businesses can exert a strong influence on government trade policy.

- According to Porter, government should invest in education, infrastructure, and basic research.