

The current nature of world trade explained by trade theories



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Outline the current nature of world trade and examine the extent to which economic trade theories of international trade explain this.

This essay will outline and discuss the current nature and pattern of world trade in contrast to international trade theories. It will attempt to justify whether these trade theories are able to explain and predict the causes of current trade patterns and whether the assumptions fit the scale of the world economy.

The continuance of globalization has played a key role in shaping the current nature and pattern of world trade. The make-up of the global economy has changed dramatically over the past few decades due to globalization and there has been a substantial increase in the volume and value of international trade facilitated by improved transportation systems, technological advances, multinational corporations and outsourcing, thus contributing to lower manufacturing costs. Supported by economic trade theories, international trade offers economic efficiency by providing a wide variety of different goods. The benefits have been well known since the discussions of absolute and comparative advantage by Adam Smith (1776), David Ricardo (1817) and the critiques by Heckscher (1919) and Olin (1933) and Leontief (1953).

More recent theories such as the Product Life Cycle theory (Vernon, 1966), the Competitive Advantage of Nations (Porter, 1990) and 'New Trade Theory' based on the assumptions of monopolistic competition, returns to scale and network externality attempt to describe the empirical elements of trade that the comparative advantage models have difficulty with.

The global trade economy is characterized by a growing level of integrated services, finance, retail, manufacturing and distribution. Total value of merchandise trade for 2009 was \$12.1 trillion down from \$15.7 trillion in 2008 due to the recent economic crisis. China have overtaken Germany as the leading exporters with a share of 9.6% of world exports however the USA remain the leading importers with a share of 12.7% of world imports. China, USA and Germany remain the top three countries in terms of the total value of imports and exports. (WTO 2010)

Export of merchandise trade is mainly in manufactured goods which contracted by 15.5% in volume terms with a total share of 68.9%, with chemicals (11.9%) and office and telecom equipment (10.9%) being the main exports. Agricultural products have a 9.6% share in total merchandise exports and fuels and mining products an 18.6% share. (WTO 2010)

In terms of commercial services trade, it now accounts for more than 20% of total trade. Total world exports in 2009 declined by 12% to \$3,350bn; the USA being the leading exporters with a share of 14.2% and the UK second with 7.2%. The services sector was hardest hit due to the economic situation with transport and financial services sectors feeling the brunt of the impact. (WTO 2010)

Many developing countries (the South¹) are now participating in international trade as there has been a shift in global trade flows. Before the 1970s, global trade was dominated by three major areas, North America, Western Europe and Pacific Asia. However this domination has now changed as industrial development arose in many developing countries, mainly South

America and most notably Asia (China, Taiwan, South Korea, Thailand and Indonesia). Many processes which took place in more developed countries have now moved to countries where there are lower production costs, mainly labour. The South currently account for more than a third of manufactured exports and have also seen a big increase in their share of commercial services trade. Asian economies increased their share of computer and information services to 27% in 2009 with India being the second-leading exporter where Europe remains the largest with a share of 56%. (WTO 2010)

Intra-regional trade currently dominates world trade. Europe accounted for 72% of all European trade, 52% of Asians exports remained within Asia and 48% of North American exports remained in North America. However for the Middle East, Africa, the Commonwealth of Independent States (CIS), and the Caribbean, their main exports destinations were Europe, Asia and North America. (WTO 2010)

Inter-regional trade is also growing with the emergence of global hubs, centred on South Africa, Brazil and China. These hubs have allowed an expansion in African exports, where most of their exports have shown maximum growth in Asia. The reason for this is most likely that Africa is fuelling manufacturing sectors in Asia. (Manoj Pant). A regional pattern emerged where manufacturing is concentrated in Asia, agriculture in the Americas (Caribbean, Central America, South America) and resource based production (mainly fuel) in Africa. (Manoj Pant).

Intra developing country trade or South-South (SS) trade has been growing in the past decade. SS exports between 1995 and 2005 increased by 197%

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compared to exports to the rest of the world which only increased by 143%. In Asia, 51% of its exports to the world went to the South and for Africa and the Americas; exports to the South were 30% and 27% of their total exports. Asia's dominance in SS exports can be explained by its size as well as its participation in international trade compared to the two other regions. Manufactured goods such as electrical products and machinery were the most traded with 37% of total SS trade, the trade of fuel was 21%, however, textiles, clothing and agricultural products declined.

These figures reveal a complex pattern of specialization in exports among SS trade. Africa imports a wide range of manufacturing goods from Asia such as textiles and electronic goods; on the other hand the majority of Asia imports from Africa are natural resources in the form of oil, minerals and base metal products. Fuel accounted for 80% of exports from Africa to the Americas and Africa imported mainly agricultural goods such as animals and vegetable products. Similarly, Asia exports to Americas consisted largely of manufactured products and America exports to Asia were largely natural based resources and agriculture. However the relationship of the trade between Asia and Americas is interesting, as the Americas imports from Asia are similar to the exports from the Americas to the developed world even though Americas have the capacity to produce manufacturing goods themselves.

One of the dominant features of global trade is regionalisation. A majority of international trade is taking place within major economical blocs particularly in the EU and NAFTA (North American Free-Trade Agreement) where a high percentage of trade is between those member nations. Blocs including <https://assignbuster.com/the-current-nature-of-world-trade-explained-by-trade-theories/>

developing countries ASEAN (Association of Southeast Asian Nations) and Mercosur are a more recent trend but trade between their member nations have a limited consistency.

Currently, more than half of world trade is Intra-Industry trade (IIT). (WDR 2009) Most of IIT is manufactured goods such as machines and transport equipment but there is also an increase in live animals and food. However, there has been a huge rise in the trade of intermediate inputs - 'the produced means of production'. Countries in East Asia have developed production networks which involve the trade of intermediate goods going back and forth. For example, Thailand will take part in certain areas in the production of televisions and then export the parts to Japan who will complete the production.

Another significant component of global trade today is the involvement of transnational corporations (TNC). TNCs are companies who are able to control operations in more than one country even though they do not own them. One of the main characteristics of TNCs is their ability to take advantage of geographical differences in the factors of production which gives them the ability to switch their resources and operations between locations at a global scale. (product life cycle)

International trade theory can be categorised into two perspectives; 'traditional' theory belonging to the neo-classical world based on homogeneous goods and perfectly competitive markets where as the other also known as 'New Trade Theory' is based on the assumptions of

differentiated goods and monopolistically competitive markets (Brulhart & Trionfetti).

Traditional trade theory concentrated mainly on the structural differences between countries. (Das) It has been dominated by Ricardo's theory of comparative advantage which claims that countries are better off if they participate in international trade. The theory of comparative advantage, an extension of Adam Smith's absolute advantage theory states that in a two good world; a country should specialize in producing and exporting goods in which it is relatively more efficient and import goods in which it is less efficient in producing (Ball & McCulloch). However, this theory does not give any explanations to what causes the relative advantage differences.

The Heckscher-Ohlin theory (H-O) takes Ricardo's theory one step further by analysing the effects of factors of production or 'factor endowments' and is able to provide an explanation for the differences in advantages for trading countries (Salvatore). The H-O theorem states that a country should produce and exports goods that require factors that are relatively abundant and import goods in which the factors of production are relatively scarce. H-O theory focuses on the endowment and cost of factors of production good whereby Ricardo's is based on efficiency.

Both of the above theories have been shown to be deficient in explaining more recent patterns of international trade. For example, the 1960s witnessed significant technological progress and the rise of the multinational enterprise, which resulted in a call for new theories of international trade to reflect changing commercial realities (Leontief, 1966). Leontief tested the

validity of the H-O theory as he found that the US was more capital in abundance but yet its exports of capital intensive goods were less than the imports however his paradox vanished as it was unable to empirically verify this statement.

At that time, the product life cycle theory of international trade was found to be a useful framework for explaining and predicting international trade patterns as well as multinational enterprise expansion. This theory suggested that a trade cycle emerges where a product is produced by a parent firm, then by its foreign subsidiaries and finally anywhere in the world where costs are at their lowest possible (Vernon, 1966, 1971; Wells, 1968, 1969). Furthermore, it explains how a product may emerge as a country's export and work through the life cycle to ultimately become an import. The essence of the international product life cycle is that technological innovation and market expansion are critical issues in explaining patterns of international trade. That is, technology is a key factor in creating and developing new products, while market size and structure are influential in determining the extent and type of international trade. While these theories are insightful a number of modern international trade theories have emerged recently which take account of other important considerations such as government involvement and regulation. However, it remains that these theories make several assumptions which detract from their potential significance and contribution to international business. For instance, they assume that: factors of production are immobile between countries; perfect information for international trade opportunities exists; and, traditional

importing and exporting are the only mechanisms for transferring goods and services across national boundaries (Bradley, 1991).

1 The Unctad publication ' The South-South trade: A reality check 2009 ' defined the South as all countries excluding the NAFTA countries, the UK, the EU-27, Russia, Australia, New Zealand and Japan.
