

# International trade theories assignment

[Business](#)



**ASSIGN  
BUSTER**

International Trade Theories Mercantilism Mercantilism was a sixteenth-century economic philosophy that maintained that a country's wealth was measured by its holdings of gold and silver (Mahoney, Trigg, Griffin, & Pustay, 1998). This required the countries to maximise the difference between its exports and imports by promoting exports and discouraging imports. The logic was transparent to sixteenth-century policy makers-if foreigners buy more goods from you than you buy from them, then the foreigners have to pay you the difference in gold and silver, enabling you to amass more treasure.

With the treasure acquired the realm could build greater armies and navies and hence expand the nation's global influence. Politically, mercantilism was popular with many manufactures and their workers. Export-oriented manufacturers favoured mercantilist trade policies, such as those giving subsidies or tax rebates, which stimulated their sales to foreigners. Domestic manufacturers threatened by foreign imports endorsed mercantilist trade policies, such as those imposing tariffs or quotas, which protected them from foreign competition (Mahoney, Trigg, Griffin, & Pustay, 1998).

Most members of society are hurt by such policies. Government subsidies of exports for selected industries are paid for by taxpayers. Mercantilist terminology is still used today, an example when television commentators and newspaper headlines report that a country suffered an 'unfavourable' balance of trade-that is, its exports were less than its imports. Mercantilist policies are still politically attractive to some firms and their workers, as mercantilism benefits certain members of society.

Modern supporters of these policies are known as neo-mercantilists, or protectionists (Mahoney, Trigg, Griffin, & Pustay, 1998). The mercantilists were a group of economists who preceded Adam Smith. They judged the success of trade by the size of the trade balance (Lipsey, & Chrystal, 1996).

**Absolute Advantage** The theory of absolute advantage, suggests that a country should export those goods and services for which it is more productive than other countries, and import those goods and services for which other countries are more productive than it is (Mahoney, Trigg, Griffin, & Pustay, 1998).

Adam Smith was the first to come up with the theory of absolute advantage. According to Adam Smith, mercantilism's basic problem is that it confuses the acquisition of treasure with the acquisition of wealth. In *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Smith attacked the intellectual basis of mercantilism and demonstrated that mercantilism actually weakens a country. Smith maintained that a country's true wealth is measured by the wealth of all its citizens, not just that of its monarch (Mahoney, Trigg, Griffin, & Pustay, 1998).

A country is said to be more productive than another country, if it can produce more output (goods) for a given quantity of input, such as labour or energy inputs. An example is that there are only two countries, Australia and Japan. They both produce computers and wine, and only one factor of production, labour. Japan produces 6 computers for every 1 bottle of wine, where as Australia produces only 4 computers for every 3 bottles of wine. This suggests that Australia should export some of its wine to Japan, and Japan should export some of its computers to Australia.

<https://assignbuster.com/international-trade-theories-assignment/>

Australia has an absolute advantage over Japan, when producing wine, and Japan has an absolute advantage over Australia, when producing computers (Gandolfo, 1998). Economists use the term absolute advantage when comparing the productivity of one person, firm or nation with that of another. The producer that requires a smaller quantity of inputs to produce a good is said to have an absolute advantage in producing that good (Gans, King, & Mankiw, 1999).

**Comparative Advantage** The theory of comparative advantage, states that a country should produce and export those goods and services for which it is relatively more productive than are other countries and import those goods and services for which other countries are relatively more productive than it is (Mahoney, Trigg, Griffin, & Pustay, 1998). David Ricardo, the early nineteenth-century British economist solved the problem of the theory of absolute advantage, by developing the theory of comparative advantage.

Absolute advantage suggests that no trade would occur if one country has an absolute advantage over both products. The differences between absolute and comparative advantage theories are subtle. Absolute advantage looks at absolute productivity differences, comparative advantage looks at relative productivity differences (Mahoney, Trigg, Griffin, & Pustay, 1998). Take Australia, and Japan again as examples, this time Australia is better than Japan at producing both products computers and wine, and only one factor of production, labour.

Australia produces 6 computers for every 4 bottles of wine, and Japan produces 5 computers for every 1 bottle of wine. Absolute advantage

suggests that no trade should occur, because Australia is more productive than Japan in producing both goods. The theory of comparative advantage, suggests that trade should still occur, as Australia is comparatively better than Japan in wine production, whereas Japan is comparatively better than Australia in the production of computers (Gandolfo, 1998). Economists use the term comparative advantage when describing the opportunity cost of two producers.

The producer who has the smaller opportunity cost of producing a good is said to have a comparative advantage in producing that good (Gans, King, & Mankiw, 1999). The Heckscher-Ohlin Theory of Factor Endowment It has been previously stated that the difference in relative commodity prices between two nations is evidence of their comparative advantage and forms the basis for mutually beneficial trade. Factor Endowments and the Heckscher-Ohlin theory take this one step further by analysing the effect that international trade has on the earnings of factors of production in the two trading nations (Salvatore, 1999).

The Heckscher-Ohlin theory presents the issue that international and interregional differences in production costs occur because of the differences in the supply of production factors (Ball, McCulloch, 1999). Those goods that require a large amount of the abundant, thus less costly factor will have lower production costs, enabling them to be sold for less in international markets (Salvatore, 1995). Countries such as Australia with relatively large amounts of land do export land intensive products (eg, grain and cattle) whereas a country like China would export labor intensive products.

There are exceptions to the Heckscher-Ohlin theory which are to do with the assumptions that Ohlin drew. One assumption was that the prices of the factor depended only on the factor endowment. This is however untrue as factor prices are not set in a perfect market. There are such factors to consider such as legislated minimum wages and benefits force the cost of labor to rise to a point greater than the value of the product than many workers can produce (Ball, McCulloch, 1999). Many economists attempted to disprove the Heckscher-Ohlin theory. The most notable effort was by a man named Wassily Leontief.

His paradox was self named (Leontief Paradox) and disputed the theory as a predictor of the direction of trade. This paradox failed to empirically validate the country based Heckschler-Ohlin theory (Mankiw, 1997). Country Similarity Theory Country similarity theory was developed by a Swedish economist named Steffan Linder (Mahoney, Trig, Griffin, Pustay, 1998). However before the country similarity theory can be analysed it is essential to understand the concept of intra industry trade. Intra industry trade is trade between two countries of goods produced by the same industry.

Intra industry trade accounts for approximately 40 per cent of world trade (Mahoney, Trig, Griffin, Pustay, 1998). Linder believed that international trade of manufactured goods occurred between countries at the same stage of economic development that shared the same consumer preferences. Therefore the country similarity theory consists of the value that most trade in manufactured goods should be between nations with similar per capita income, and that intra industry trade in manufactured goods should be common (Mahoney, Trig, Griffin, Pustay, 1998).

<https://assignbuster.com/international-trade-theories-assignment/>

International Product Life Cycle Theory (IPLC) The International product life cycle theory is a valuable instrument in analysing the effects of product evolution on the global scale. The IPLC generally applies to established companies in industrialised countries who expand their product range. The theory is broken up into five major areas; Release: As competition in Industrialised countries tends to be fierce, 'Manufactures are therefore forced to search constantly for better ways to satisfy their customer needs. (Ball et al, 1999). The core elements in new product design are gained from customer feedback from previous models. Once the product enters the domestic market and begins to create a positive reputation, the demand increases and hence we come to an end of the first stage of the IPLC. Exports: As the product receives positive customer response, the international demand for the product begins. The manufacturer begins exporting to increase its market share. An example of this was the personal computer (PC) craze of the early 80's.

In 1985 55, 000 PCs were sold in the United States, by 1984 the industry had experienced a 136-fold increase to 7 million PCs (Richter-Buttery, 1998)

Foreign Production begins: As demand increases with the new global market, it becomes economically feasible to begin local production in various nations. By sharing technology on the manufacturing of the product, the company has lost an advantage. The end of this stage signifies the highest point in the International Product Life Cycle Theory. Foreign Competition in exports markets: This is a threatening stage for the company.

Local manufactures have gained experience in producing and selling their product, hence their costs have fallen. As they have saturated their initial

<https://assignbuster.com/international-trade-theories-assignment/>

market, they may begin to look elsewhere (ie. Other nations) to promote their product. The reason that this is threatening for our company is that this other nation may have a competitive advantage and this places stress on our market share. Import Competition in Home Market: If the competitors have a competitive advantage, or they reach the economies of scale needed, they will enter the original home market.

At this stage the competitors will have a quality product which will be able to undersell the original manufactures. Eventually they will be pushed out from the market and imports will supply the home nation. Eventually, as the product's technology becomes more renowned, developing nations will enter the market. This will begin the International Product Life Cycle again, as these nations have a competitive edge with their low labour costs. ' With future innovations and new products and services the eventuality is that it's value and hence its price are likely to diminish' (Lendrum, 1995). The IPLC theory does have its disadvantages.

Perhaps the most recognisable is the assumption that products are released initially in the domestic markets. Many globalised companies tend to release their new product lines internationally, not domestically, hence this theory can not be applied to many of today's products. Porter's Theory of National Competitive Advantage/Porter's Diamond Michael Porter's book The Competitive Advantage of Nations, published in 1990 was based on a study of 100 firms in 10 developed nations. Porter develops a new theory of how nations, states, and regions compete and their sources of economic prosperity.



Porter questions how Switzerland, a nation with few natural resources, is a world leader in the production of chocolates, and Japan, a country whose economy was in shambles after World War 2, is now a global leader in making low cost, mass-produced, quality, high-technology products. Porter outlines a number of factors for this that go beyond natural resources, among these are; a sizeable demand from sophisticated consumers, an educated and skilled workforce, intense competition in the industry, and the existence of related and supporting suppliers.

Porter also discusses external influences such as government and chance

**Demand Conditions:** Porter argues that companies should be ‘ participating in national markets with the strongest rivals and most demanding customers, in order to build international competitiveness’ (Yip, 1995). A company faced to more competitive forces will strive to make themselves more efficient in order to have an edge over their competitors and maximise profits.

**Factor Conditions:** Each nation possesses what economists have termed factors of productions.

Factors of production are nothing more than the inputs to compete in any industry, such as Labor, arable land, natural resources, capital, and infrastructure. The factors most important to competitive advantage in most industries, especially in the industries most vital to productivity growth in advanced economies, are not inherited but are created within a nation, through processes that differ widely across nations and among industries.

[http://members.tripod.lycos.nl/Japan\\_industry/three.tml](http://members.tripod.lycos.nl/Japan_industry/three.tml) Related and

**Supporting Industries:** There has been an unexplained trend on why companies, suppliers, competitors and supporting industries tend to

<https://assignbuster.com/international-trade-theories-assignment/>

congregate in close proximity to each other. This focuses on competition within the domestic market. In other words, when a new industry emerges in one country, domestic suppliers start competing for business. Thus through this competition, quality is bound to increase and prices will decrease which in turn reinforces and gives the industry a competitive advantage in the international market.

**Firm Strategy, Structure and Rivalry:** The fourth broad determinant is the context in which firms are created, organised and managed as well as the nature of domestic rivalry. The pattern of rivalry at home also has a profound role to play in the process of innovation and the ultimate prospects for international success (Porter, 1980). A firm strategy & competition in domestic market shapes its performance in the international market. In some cases strategies used in the domestic market can be applied internationally with little or no modifications. However, sometimes it is not so easy.

**Global Strategic Rivalry Theory** The Global Strategic Rivalry theory was developed in the 1980s as a means to ‘ examine the impact on trade flows arising from global strategic rivalry between Multi National Corporations. ‘ (Mahoney, et al 1998). It explores the notion that in order to stay viable, firms should exploit their competitive advantage globally and try to keep it sustainable. There are many ways in which a firm can hold a competitive advantage, these include; Owing intellectual property rights??? Investing in research and development??? Achieving economies of scale or scope??? Exploiting the experience curve??? A good example of strategic alliance, which gave two companies a competitive advantage, is Qantas and British <https://assignbuster.com/international-trade-theories-assignment/>

Airways. Qantas had solid air route throughout the Asia Pacific region, likewise British airways had strong network within Europe, North Atlantic, and North America. By forming an alliance in 1993, both companies strategically positioned themselves to have a strong worldwide network. This global strategic rivalry theory gave them a competitive advantage. (Mahoney, et al 1998).