Mercantilism and theories of international trade

ASSIGN BUSTER

During the period 1400-1800, a group of writers appeared in Europe was concerned with the process of nation building who were famously known as Mercantilists. Until the end of the eighteenth century, most statesmen in Europe believed in mercantilist approach to trade and particularly it prevailed in England during first Queen Elizabeth's time (1558 to 1603) and Queen Victoria's era (1837 to 1901). Much of the underpinning of free enterprise system was developed in late eighteenth century and early nineteenth century. Mercantilism took many forms, but essentially it was a belief that national power depended upon national economic wealth. Wealth was at that time equated with possession of precious metals such as gold and silver[1]. According to the mercantilists, the central question was how a nation could regulate its domestic and international affairs so as to promote its own wealth. The solution lay in a strong foreign-trade sector. Mercantilism advocates, building up a surplus of exports over imports to increase the stock of bullion. This excess of exports over imports was referred as favourable balance of trade by the mercantilist (1767) even though ' balance in our favour' had been used by John Cary[2](1695) earlier. They believed that, such revenues would contribute to increase spending which leads to a rise in domestic output and employment. To promote a favorable trade balance, the mercantilists advocated government regulation of trade. Tariffs, quotas, and other commercial policies were proposed by the mercantilists to minimize imports in order to protect a nation's trade position. Mercantilist ideas were never universally accepted, and economic policy measures associated with them were enforced only half-heartedly. By the end of eighteenth century, the economic policies of the mercantilists were under strong attack. Mercantilist doctrine was criticized by David Hume in his '

Political Discourses' (1752). Hume claimed that given a free market in bullion, and internal price flexibility, any attempt by a country to build up a long-term favourable balance of trade was fore-doomed to failure. According to David Hume's price-specie-flow doctrine, a favorable trade balance was possible only in the short run, for over time it would automatically be eliminated. The mercantilists were also attacked for their static view of the world economy. To the mercantilists the world's wealth was fixed. This meant that one nation's gains from trade came at the expense of its trading partners; not all nations could simultaneously enjoy the benefits of international trade. This view was challenged by the publication of Adam Smith's (1776) ' Wealth of Nations'. According to smith the world's wealth is not a fixed quantity and he argued that international trade permits nations to take advantage of specialization and the division of labour, which increase the general level of productivity within a country and thus increase world output (wealth). Smith's view of trade suggested that both trading partners could simultaneously enjoy higher levels of production and consumption with trade. He advocated free trade on the grounds that it promoted the international division of labour. But of the advantages of free trade as a general rule he was in no doubt. It is important to realize the limitation of Adam Smith's free trade argument. He demonstrated that two countries would gain from specialization when one was more efficient than another at producing a product but less efficient than its partner at producing another product (Absolute Advantage). But it was left to a later writer, Ricardio, to show that there might be a gain even one country was better than its partner at producing both products. This was the famous principal of comparative advantage.

David Ricardo (1817) in his Principles of Political Economy was the first writer systematically applies this principle of comparative advantage or comparative costs to trade between countries. In doing so Ricardo made a substantial advance from Adam Smith's position, Whereas Smith showed that trade between two countries were profitable if each had an absolute advantage over the other in the production of a commodity, Ricardo showed that gain was also possible in cases where one country had an absolute advantage over the other in the production of both commodities, but whereas its advantage was greater in one commodity than in other. The situation as outlined by Ricardo could not exist within a single country but since labour and capital are not mobile between countries, differences in costs can persist. In the original Ricardian model, the most important factor affecting the pattern of international trade was the difference in labour time costs. Ricardo's emphasis upon labour time costs certainly attracted criticism. Naussau Senior (1830) pointed out that it was misleading to explain trade primarily in terms of labour time, since money cost differentials might reflect productivity differentials rather than differences in the length of labour time required to produce a commodity. Senior fixed attention on labour productivity rather than on the relative amount of labour time devoted to producing various products[3]. A similar criticism of Ricardo was advanced by J. S. Mill, who argued that since special factors might depress wages in certain industries, but not in the other industries in the same country, the products of those industries whose wages were ' artificially' low might sell at relatively low prices. Marshall, for example, endeavoured to include capital and other production costs along with labour costs by his use of the concept of a ' representative bundle' of a nation's factors of

production consisting of a given amount of labour working with an average amount of capital. All these were attempts to develop a more realistic measure of costs than one which took account only of Ricardo’s labour time costs. But they had a common notion that differences in comparative real costs determined comparative advantage. Although each made a valuable contribution to theory, neither Senior, Mill or Marshall attempted a full examination or reformulation of Ricardo’s doctrine. This was left to taussig (1927) who paid a very careful attention to the role of factors other than labour costs in international specialization. In particular he examined the part played by the relative cost of capital, namely relative interest rates. A number of writers attacked the classical position on the grounds that it presupposed a two country and two commodity world. Others criticized the absence of any discussion about transport costs. A number of writers in the classical tradition tried to accommodate comparative cost theory to the real world situation where more than two commodities normally exchange between two countries. Perhaps the best known and most useful contribution in this field was that of von Mangoldt- Edgeworth[4]. Their approach admits that in a many commodity world, knowledge of real costs alone is insufficient to show which commodities will be imported and exported by any given country. In order to determine the pattern of import-export trade, one needs to know the relative money wage rates in the two countries. An obvious omission so far is the absence of any consideration of transport costs and early international trade theory paid very little attention to transport costs. The existence of transport costs may well affect the profitability and pattern of international trade. In 1930’s, fundamental changes were occurred in attitudes towards the real cost theory of international trade. One of the most

significant developments was the contribution of Professor Gottfried Haberler's (1933) in his ' Theory of International Trade'. He pleaded for a restatement of international trade theory in terms of opportunity rather than real cost. But according to Heckscher and ohlin, trade between nations is profitable when it enables them to take advantage of their differencing factor endowments. H-O approach is an awareness of the relationship between trade and domestic economic structure. However it has been criticized by the later writers. One of the most interesting criticism of the H-O approach as applied to trade in manufactures is by S. Linder[5](1961) who argues that so far from being explicable by differences in factor endowments, trade in manufactures is explained by similarity in demand patterns. In contrast to much earlier theorizing, the Linder approach emphasizes the role of demand conditions in making trade worthwhile. A rather different criticism of the Heckscher – Ohlin approach comes from Kravis, who argues that, the determinant of trade pattern is ' avaliability' or supply elasticity within trading countries rather than their relative factor endowments. One of the ironies of the history of economic thought is the almost complete neglect by nineteenth century classical economists of the movement of factors between countries, both of human beings and capital. Ricardo and his successors accordingly failed to work out the relationship between factor movements and commodity trade. But in the real world there is both factor and commodity movement exists.

The most drastic changes in the world economy have been due to the international flows of factors of production, including labour and capital. In the 1800s, European capital and labour (along with African and Asian labour)

flowed to United States and later US has sent large amounts of investment capital to Canada and Western Europe. Although the free trade argument tends to dominate, virtually all nations have imposed restrictions on the international flow of goods, services and capital. The advocates of protectionism says that free trade is fine in theory, but it does not apply in the real world because the modern international trade theories assumes perfectly competitive markets whose characteristics do not reflect real-world market conditions. Despite the power of free trade argument, however, free-trade policies met major resistance among poorer nations whose companies and workers faced losses in income and jobs because of unfair competition. Domestic producers contend that import restrictions should be enacted to offset these foreign advantages, thus creating a level playing field on which producers can compete on equal terms. All developed countries have used protectionism prior to the 19th century and also the damage caused by the wars for trade such as, colonial wars, opium wars and world war I made the economies to protect their own interest. During 18th and 19th century majority of the economies in the world had implied barriers (tariff and non-tariff barriers) for free trade to protect unfair competition. But many liberal economist of the 20th century such as John Stuart Mill, Cordell Hull has advocated free trade. The British economist John Maynard Keynes criticized of the Treaty of Versailles in 1919 for the damage it did to the interdependent European economy and later he advocated free trade because he believed that it promotes high levels of employment. The tremendous growth of productive forces utilizing the scientific and technological advances in developed economies has resulted in huge growth of their output and this expansion leads them to the search for new markets.

Since World War II the trend has been in favor of free trade. Finally, the General Agreement on Tariffs and Trade (GATT) (1944) has sponsored a number of initiatives for free trade. The United States has played an instrumental role in the several GATT initiatives, including the Uruguay round (1986-93), which negotiated the Trade Related Investment Measures (TRIMS) and later it becomes the part of WTO. The neoliberal and modern economist divorce the traditional theory and tend to discuss that both labour and capital are mobile between nations.

There are a number of modern theories explaining FDI, amongst one of the earliest theories was developed by MacDougall (1958) and later elaborated by M. C. Kemp (1964). MacDougall-Kemp developed marginal productivity theory to analyze income effects and assessed the balance of costs and benefits accruing to the different sectors of the host economy. The decrease in the marginal productivity of capital due to the increase in capital stock due to FDI has counterbalanced by the higher marginal returns to labor in the host economy. Since the gain to the labor sector exceeds the loss to the capitalist sector, it follows that FDI yields net positive income effects to the host country. In case of the investing country, return on capital invested will be equivalent to marginal productivity of capital outflow. But the limitation in MacDougall's theory is based on the assumption of perfect competition and FDI takes place in the traditional sectors such as production of primary commodities or basic industrial manufacturing. In the real world perfect competition does not exist and FDI activities began to venture into new sectors such as technology or knowledge-based or modern capital-intensive manufacturing. Under these circumstances, decline in capital productivity

needs not be a realistic consideration. Except MacDougall-Kemp hypothesis, FDI theories are primarily based on imperfect market conditions.

One of the earliest theories based on the assumptions of an imperfect or oligopolistic market was the industrial organization theory developed by Stephen Hymer. Hymer (1960) explains that firm specific advantages are mainly due to the technological advantage which helps the multinational firms to produce a new product different from the existing one. The important aspect of this theory is that, the technological advantages are transferred more effectively from the parent unit to its subsidiary in the host county irrespective of the geographical distance. The multinational firm harvests huge profits because of non-availability of technological advantage to the rival in the imperfect market. Graham and Krugman (1989) proved this hypothesis empirically that, it was the technological advantage possessed by European firms that had led them to invest in the USA. Caves (1971) also feels that firm- specific advantages are transmitted more effectively if the firm participates effectively in the production in the host country than through other ways such as export or licensing agreements. The industrial organization theory has also been acknowledged by Kindle berger (1969), Johnson (1970). They explained that the important determinant of FDI is the advantages of superior knowledge and economies of scale that allow a multi-national firm to operate its subsidiary aboard profitably than the local competitors.

Another earliest theory based on the assumptions of an imperfect market was developed by Raymond Vernon who played a significant role in the post-World war development of GATT. The mobility of capital in the

internationalization process has discussed in his famous International Product Life Cycle model (IPLC). Vernon (1966) argued that every product follows a life cycle which is divided into three stages viz., innovation stage, maturing product stage and standardized product stage. Initially the firm innovates a product to meet the domestic demand and a portion of output has been exported to other economies. Then in the next stage the rivals in the host country produces similar product at a lower price whereas the product of the innovator is often costlier because of the transportation cost and tariff imposed by the host government. At the final stage, price competitiveness becomes more important; and in view of this fact, the innovator shifts the production to a low cost location. Foreign Direct Investments (FDI) in production plants drive down unit cost because of labour and transportation cost decrease. The product manufactured in a low cost location is exported back to the home country or to other developed countries or marketed in the host country itself. The product cycle theory explains the early post-World War situation but with the changes in international trade environment, the stages of the product life cycle did not necessarily follow in the same way. Vernon (1979) himself had discussed about this limitation in his later writing, that even in the second stage itself firms were moving to the developing world to reap the advantages of cheap labour. Bhagwati (1972) criticized that, export threat not always cause a firm to set up a subsidiary in the host country. He argues that if it is true, all US firms should have set subsidiaries abroad in countries to which they had been exporting. Hood and Young (1979) emphasized upon the location-specific advantages. They explain that since real wage cost varies among countries, firms move to low wage countries. Sometimes it is the availability

of cheap and abundant raw material that encourages the MNCs to invest in the county with abundant raw material. Buckley and Casson (1976) also assume market imperfection, but in their view imperfection is related to the transaction cost which is involved in the intra-firm transfer of intermediate products such as knowledge or expertise. The transaction cost in case of intra-firm transfer of technology is almost zero, whereas in case of technology transfer to other firms is extremely high. This view is more or less in similar with the appropriability approach of Magee (1979), which emphasizes on the potential returns from technology creation as a prime mover behind internationalization of firms. Many critics of course argue that intra-firm transaction cost may not necessarily be low. If subsidiaries are located in a new environment, the transaction cost is usually high. Kogut and Parkinson (1993) opine that if the transaction cost is very large if the transfer of intermediate goods involves substantial modification of well established practice. Franke, Hofstede, and Bond (1991) are of the view that, the internalization process will be a costly affair, if the cultural differences between the home country and the host country are wide. The major combination of imperfect market-based theories of FDI is Dunning's eclectic paradigm[6]. It explains that at a given point of time the stock of foreign assets owned by a multinational firm is determined by a combination of ownership advantage (O), the extent of location bound endowments (L) and the extent to which these advantages are marketed in the host country (I). Dunning (1993) believes that pattern of O-L-I advantages varies between countries and activities. Foreign investment will be greater where the arrangement is more prominent. Later, he introduced a " dynamised add-on" variable to his theory which is strategic change. The O-L-I configuration

varies according to strategies adopted by the multi-national firms, which is evident from the fact that market seeking investment has a different O-L-I configuration from that of a resource based investment. Finally it has been empirically tested and proved by Dunning (1980, 1993), that is the varying configuration shapes the direction and pattern of FDI.