UNIT II

THEORIES OF INTERNATIONAL TRADE AND INVESTMENT

PART I

Syllabus: Theories of International Trade: Mercantilism, Absolute Advantage Theory, Comparative Cost Theory, Hecksher-Ohlin Theory-Theories of Foreign Direct Investment : Product Life Cycle, Eclectic, Market Power, Internationalisation -Instruments of Trade Policy : Voluntary Export Restraints, Administrative Policy, Anti-dumping Policy, Balance of Payment.

Theories of International Trade

Classical Trade Theories

Adam Smith and David Ricardo gave the classical theories of international trade.

According to the theories given by them, when a country enters in foreign trade, it benefits from specialization and efficient resource allocation.

The foreign trade also helps in bringing new technologies and skills that lead to higher productivity.

The assumptions taken under this theory' are as follows:

a. There are two countries producing two goods.

b. The size of economies of these countries is equal

c. There is perfect mobility of factors of production within countries

d. Transportation cost is ignored

e. Before specialization, country's resources are equally divided to produce each good

The classical theories are divided into three theories, as shown in Figure-3:

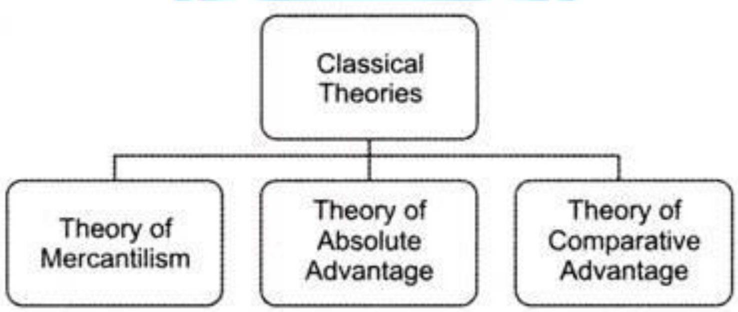


Figure-3: Classical Trade Theories

Theory of Mercantilism:

Mercantilism is the term that was popularized by Adam Smith, Father of Economics, in his book, The Wealth of Nations. Western European economic policies were greatly dominated by this theory. The theory of mercantilism holds that countries should encourage export and discourage import.

It states that a country's wealth depends on the balance of export minus import. According to this theory, government should play an important role in the economy for encouraging export and discouraging import by using subsidies and taxes, respectively. In those days, gold was used for trading goods between countries.

Thus, export was treated as good as it helped in earning gold, whereas, import was treated as bad as it led to the outflow of gold. If a nation has abundant gold, then it is considered to be a wealthy nation. If all the countries follow this policy, there may be conflicts, as no one would promote import. The theory of mercantilism believed in selfish trade that is a one-way transaction and ignored enhancing the world trade. Mercantilism was called as a zero-sum game as only one country benefitted from it.

Theory of Absolute Advantage:

Given by Adam Smith in 1776, the theory of absolute advantage stated that a country should specialize in those products, which it can produce efficiently. This theory assumes that there is only one factor of production that is labor.

Adam Smith stated that under mercantilism, it was impossible for nations to become rich simultaneously. He also stated that wealth of the countries does not depend upon the gold reserves, but upon the goods and services available to their citizens.

Adam Smith wrote in The Wealth of Nations, "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage".

He stated that trade would be beneficial for both the countries if country A exports the goods, which it can produce with lower cost than country B and import the goods, which country B can produce with lower cost than it.

An example can be used to prove this theory. Suppose there are two countries A and B, which produce tea and coffee with equal amount of resources that is 200 laborers. Country A uses 10 laborers to produce 1 ton of tea and 20 laborers to produce 1 ton of coffee. Country B uses 25 units of laborers to produce tea and 5 units of laborers to produce 1 ton of coffee.

This is shown in Table- 1:

Table-1: Resources used to produce a ton of Tea and Coffee without Trading

	Country A	Country B
Tea	10	25
Coffee	20	5

It can be seen from Table-2 that country A has absolute advantage in producing tea as it can produce 1 ton of tea by using less laborers as compared to country B. On the other hand, country B has absolute advantage in producing coffee as it can produce 1 ton of coffee by employing less laborers in comparison to country A.

Now, if there is no trade between these countries and resources (in this case there are total 200 laborers) are being used equally to produce tea and coffee, country A would produce 10 tons of tea and 5 tons of coffee and country B would produce 4 tons of tea and 20 tons of coffee. Thus, total production without trade is 39 tons (14 tons of tea and 25 tons of coffee).

Table-2 shows the production without the trade between country A and country B:

Table-2: Production without Trade		
	Country A (in tons)	Country B (in tons)
Tea	10	4
Coffee	5	20

If both the countries trade with each other and specialize in goods in which they have absolute advantage, the total production would be higher. Country A would produce 20 tons of tea with 200 units of laborers; whereas, country B would produce 40 tons of coffee with 200 units of laborers. Thus, total production would be 60 units (20 tons of tea and 40 tons of coffee).

The production of tea and coffee after trade is shown in Table-3:

Table-3: Production with Trade		
	Country A (in tons)	Country B (in tons)
Tea	20	0
Coffee	0	40

Without specialization, total production of countries was 39 tons, which becomes 60 tons after specialization. Therefore, the theory of absolute advantages shows that trade would be beneficial for both the countries.

Theory of Comparative Advantage:

Many questions may come in mind after reading the absolute advantage theory that what would happen if a country has absolute advantage in all the products or no absolute advantage in any of the product. How such a country would benefit from trade? The answers of these questions was given by David Ricardo in his theory of comparative advantage, which states that trade can be beneficial for two countries if one country has absolute advantage in all the products and the other country has no absolute advantage in any of the products.

According to Ricardo, "…a nation, like a person, gains from the trade by exporting the goods or services in which it has its greatest comparative advantage in productivity and importing those in which it has the least comparative advantage. "

This theory assumes that labor as the only factor of production in two countries, zero transport cost, and no trade barriers within the countries. Let us understand this theory with the help of an example.

Suppose there are two countries A and B, producing two commodities wheat and wine with labor as the only factor of production. Now assume that both the countries have 200 laborers and they use 100 laborers to produce wheat and 100 laborers to produce wine.

Table-4 shows the production of wheat and wine in Country X and Country Y before trade:

Table-4: Situation of Country X and Country Y before Trade		
	Country X	Country Y
Wheat	20	15
Wine	40	10

Table-4 depicts that country X can produce 20 units; whereas, country Y can produce 15 units of wheat by using 100 laborers. In addition, country X can produce 40 units; whereas, country' Y can produce 10 units of wine by employing 100 laborers.

Thus, country X has absolute advantage in producing both the products. As already discussed, country X employs same number of laborers (100 laborers in production of each good) in producing both wine and wheat; however, the production of wine is more than the production of wheat.

It shows that country' X has comparative advantage in producing wine. Similarly, country Y also employs same number of laborers (100 laborers in production of each good) in manufacturing wheat and wine; however, its production of wheat is more than the wine. It indicates that country Y has comparative advantage in manufacturing wheat.

For example, country X has decided to produce 60 units of wine by employing 150 laborers. It uses 50 laborers to produce 10 units of wheat. On the other hand, country Y has decided to use all the 200 laborers to produce 30 units of wheat. It would not produce any unit of wine.

This data is represented in Table-5:

Table-5: Production of Country X and Country Y after Specialization

	Country X	Country Y
Wheat	10	30
Wine	60	0

Now, country X exchanges 14 units of wine with 14 units of wheat produced by country Y.

The situation of both the countries after trade is shown in Table-6:

Table-6: Situation of Country X and Country Y after Trade

	Country X	Country Y
Wheat	24	16
Wine	46	14

It can be observed from Table-6 that both the countries have gained from trade. Before trade, country X has 20 units of wheat and 40 units of wine; however, after trade, country Y has 24 units of wheat and 46 units of wine.

On the other hand, country Y has 15 units of wheat and 10 units of wine before trade; however, it has 16 units of wheat and 14 units of wine after trade. Therefore, comparative advantage explains that trade can create benefit for both the countries even if one country has absolute advantage in the production of both the goods.

Modern Theories

There are many theories and concepts associated with international trade. When companies want to go international, these theories and concepts can guide them to be careful and prepared.

There are four major modern theories of international trade. To have a brief idea, please read on.

The Heckscher and Ohlin Model

The Heckscher–Ohlin theory deals with two countries' trade goods and services with each other, in reference with their difference of resources. This model tells us that the comparative advantage is actually influenced by relative abundance of production factors. That is, the comparative advantage is dependent on the interaction between the resources the countries have.

Moreover, this model also shows that comparative advantage also depends on production technology (that influences relative intensity). Production technology is the process by which various production factors are being utilized during the production cycle.

The Heckscher–Ohlin theory tells that trade offers the opportunity to each country to specialize. A country will export the product which is most suitable to produce in exchange for other products that are less suitable to produce. Trade benefits both the countries involved in the exchange.

The differences and fluctuations in relative prices of products have a strong effect on the relative income gained from the different resources. International trade also affects the distribution of incomes.

Theories of Foreign Direct Investment

Product Life Cycle Theory – (Vernon's Product Life Cycle Theory)

Product Life Cycle Theory is an economic theory that was developed by Raymond Vernon in response to the failure of the Heckscher-Ohlin model to explain the observed pattern of international trade. The theory suggests that early in a product's life-cycle all the parts and labor associated with that product come from the area where it was invented. After the product becomes adopted and used in the world markets, production gradually moves away from the point of origin. In some situations, the product becomes an item that is imported by its original country of invention. A commonly used example of this is the invention, growth and production of the personal computer with respect to the United States.

Raymond Vernon divided products into three categories based on their stage in the product life cycle and how they behave in the international trade market:

- New Product
- Maturing Product
- Standardized Product

In the new product stage, the product is produced and consumed in the US; no export trade occurs. In the maturing product stage, mass-production techniques are developed and foreign demand (in developed countries) expands; the US now exports the product to other developed countries. In the standardized product stage, production moves to developing countries, which then export the product to developed countries.

The model demonstrates dynamic comparative advantage. The country that has the comparative advantage in the production of the product changes from the innovating (developed) country to the developing countries. This model is developed in 1960 and lagerly accepted by US and other developed countries.

Vernon argued that firms undertake FDI at particular stages in the lifecycle of a product they have pioneered. Vernon suggests that a product goes through three stages: it starts of as a new product, and then becomes a maturing product and finally a standardized product.

In the new product stage the product is invented by a country, which is usually an advanced country with high-tech advantage in response to domestic demand, more skilled labour is needed for testing and adjusting the product.

In the maturing stage the product becomes standardized gradually and mass production begins, less skilled labour is needed and capital becomes more important. The product is marketed internationally and in search of export markets, producers look for similar markets in similar advanced countries. With increase in exports, producers begin to consider locating closer to these markets.

The final stage is the standardization stage where factors such as production and location cost are vital in determining location decisions and usually the product is made in other countries and imported to the original producing country. Gradually production and export from the original country ceases and subsequently production is shifted to less developed countries.

An illustration is the photocopier which was first developed in the 1960's by Xerox in the United States and sold in the U.S. only. Initially, Xerox exported photocopiers mainly to Japan and advanced countries of Western Europe. As demand grew in those countries, Xerox entered into joint ventures and set up production in Japan (Fuji-Xerox) and Britain (Rank-Xerox). Once Xerox's patents on the photocopier expired, other foreign competitors entered the market such as Canon in Japan. As a result of this, U.S. exports declined and U.S. users began buying from mostly Japan due to lower costs. In recent times, Japanese companies have begun to switch production to LDC's such as Singapore and Thailand due to high manufacturing costs in Japan.

Product life-cycle

There are five stages in a product's life cycle in respect to the Product Life Cycle Theory:

- Introduction
- Growth
- Maturity
- Saturation
- Abandonment

The location of production depends on the stage of the cycle.

According to International Product Life Cycle theory there are five phases which describe how a product matures and declines as a result of internationalization:

·Local Innovation

·Overseas Innovation

·Maturity

·World Wide Imitation

·Reversal

Dunning's Eclectic Theory

Dunning's eclectic theory combines ownership advantage, internalization advantage to form a unified theory of FDI.

According to Dunning, FDI will occur when 3 conditions are satisfied

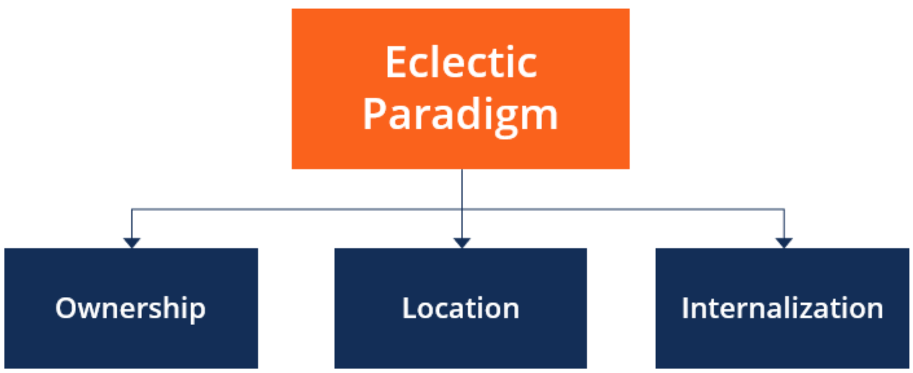
1. Ownership Advantage: The firm must own some unique competitive advantage that overcomes the disadvantages of competing with foreign firms on their home turfs. This advantage may be a brand name, ownership or proprietary technology, the benefits of economies of scale and so on.

2. Location Advantage: Undertaking the business activity must be more profitable in a foreign location than undertaking it in a domestic location.

3. Internalization Advantage: The firm must benefit more from controlling the foreign business activity than from hiring an independent local company to provide the service.

Eclectic Paradigm

Based on the internalization theory of British economist J.H Dunning, the eclectic paradigm is an economic and business method for analyzing the attractiveness of making a foreign direct investment (FDI). The eclectic paradigm model follows the OLI framework. The framework follows three tiers – ownership, location, and internalization.



The eclectic paradigm assumes that companies are not likely to follow through with a foreign direct investment if they can get the service or product provided internally and at lower costs.

Ownership Advantage

The ownership advantage can also be seen as the competitive advantage that comes with the FDI. Ownership can be defined as the proprietorship of a unique and valuable resource that cannot easily be imitated, thereby creating a competitive advantage against potential foreign competitors.

The intrinsic disadvantages or challenges associated with FDIs, in terms of ownership, circle around the liabilities that come with foreignness since the potential investor is a non-native in the country that the FDI will be made. The challenges can include (but are not limited to) possible language barriers or lack of knowledge of the demand trends that are common among the local consumer markets.

Companies and their management teams normally need to consider the possibilities of transference of the competitive advantage to other foreign markets in order to counterbalance the liabilities mentioned above. Ideally, an attractive investment should include notable economies of scale, a sound reputation, and a well-known brand name, advanced technology, etc.

Location Advantage

The potential business host countries being considered for FDIs must present numerous competitive advantages; location is one of them. The location advantage focuses more on the geographic advantages of the host country or countries. An example of a geographic advantage can be access to the ocean (for sea freight or other purposes) versus a land-locked country.

Other location advantages can include low-cost labor and raw materials, lower taxes and other tariffs, a well-trained labor force, etc. Normally, the Porter's diamond model can be used to evaluate location advantages.

Companies and their management teams normally need to consider whether any location advantages, as mentioned above, exist in the market they wish to enter. Should the advantages exist, the companies can consider taking on the investment through an FDI or other pathways (e.g., franchising or licensing) provided that there is a demand in the foreign markets.

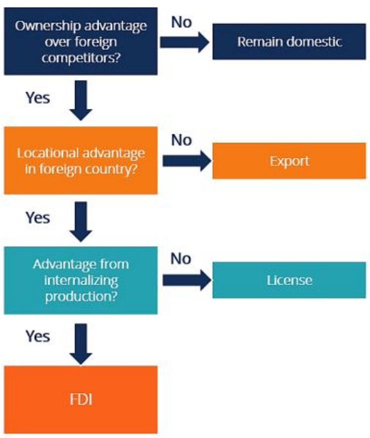
Internalization Advantage

In order for companies to choose which investment pathway or method is best suited for their needs, their management team must analyze the internalization advantage. They normally need to consider whether it would be more sensible to get the value chain activity performed locally with their own team or outsource it to a foreign country.

The advantages of outsourcing from different countries can include (but are not limited to) lower costs and better skills to perform the value chain activities and/or better knowledge of the local markets.

In such a case, management can choose between two options on how to proceed. It can either outsource its production to an original equipment manufacturer (OEM) or license its product design to an independent foreign company

If the company does so, however, it should keep control over its activities and engage in FDI. It can be done by starting from scratch through a greenfield investment, entering into joint ventures with local partners, or purchasing existing local companies.



Capital Market/Market Power Theory

The capital market theory is a part of portfolio investment theory and is considered one of the oldest theories that explain the idea behind expansion of firms abroad. According to this approach, FDI is determined mainly by interest rate and the value of host country's currency. Aliber (1971) argued that firms are more likely to expand abroad when their currency value in the home country is strong. While, firms that hosted by countries with a weak currency avoid investing abroad. Moreover, higher currency fluctuations in the host countries encourage foreign firms to borrow money at lower interest rate than domestic companies. According to Boddewyn(1985), the capital market theory explained the reasons behind firms’ investment abroad, where he mentioned three situations which encourage firms to expand their activities overseas. Firstly, lower (undervalued) exchange rate in the host country, which allows lower production costs in the host countries. Second, the absence of organized securities markets in the less developed countries, the matter that encourages FDI rather than purchases of securities. Third, the lack of information about securities markets in these countries. That is why it favors FDI which allows control of host country assets.

Internationalization Theory

The internationalization theory sought to provide another explanation for FDI through concentrating on intermediate inputs and technology. This theory was founded by Buckley and Casson (1976) based on the seminal work of Coase (1937), where they attempted to answer the question why production is carried out by the same firm in different locations.

In this context, Buckley and Casson (1976) and Hennart (1982) developed the theory of internalization which relied mostly on the assumption of market imperfections, where the firms expand their activities abroad to overcome the market failure and to enhance their monopolistic advantage. The central assumption of this theory is that the established multinational enterprises are motivated to reduce transaction cost related to failures in the market for intermediate products, the matter that raises the profitability of these firms.

Buckley and Casson (1976) classified several types of market failure that result in internalization. For example, the government interventions in markets create an incentive for transfer pricing as well as the inability to estimate the prices correctly.

According to Buckley and Casson (2009) internalization takes place as a result of the market failure in intermediate input markets, which lead to horizontally integrated MNEs (horizontal FDI). Moreover, due to market failure in the intermediate output markets which lead to a vertical integrated MNEs (vertical FDI).

Internalization Theory

Internalization theory addresses the question of why firms choose FDI over the other possibilities (listed above). It does so by heavily relying on the concept of transaction costs

 Transaction costs are the costs of entering into a transaction, that is, those connected to negotiating, monitoring and enforcing a contract.

 A firm must decide whether it is better to own and operate its own factory overseas or to contract to with a foreign firm

 Internalization theory suggests that FDI is more likely to occur- that is, int’l production will be internalized within the firm- when the costs of negotiating, monitoring and enforcing a contract with a second firm are high.

 Conversely, internalization theory holds that when transaction costs are low, firms are more likely to contract with outsiders and internalize by licensing their brand names or franchising their business operations.