6. Theories of International Trade and Investment
Read chapter 6
Learning Objectives

1. Theories of international trade and investment
2. Why do nations trade?
3. How can nations enhance their competitive advantage?
4. Why and how do firms internationalize?
5. How can internationalizing firms gain and sustain competitive advantage?
Nation-level Explanations

Firm-level Explanations
Comparative Advantage

How **NATIONS** can achieve and sustain economic success?

Superior features of a country providing unique benefits in global competition.

**What are superior features based on?**

- **Natural endowments/inherited resources**
  - e.g., labor, climate, arable land, petroleum reserves, etc.

- **Deliberate national policies**
  - create comparative advantages over time
  - e.g., entrepreneurial orientation, availability of venture capital, innovative capacity, etc.

**Example:**

<table>
<thead>
<tr>
<th>Country</th>
<th>Comparative advantage</th>
<th>Product</th>
<th>Comparative advantage based on</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>The climate and soil</td>
<td>Wine</td>
<td>Natural endowments / inherited resources</td>
</tr>
<tr>
<td>India</td>
<td>IT workers</td>
<td>Computer software</td>
<td>Deliberate national policies</td>
</tr>
</tbody>
</table>
How **FIRMS** gain and maintain distinctive competencies, relative to competitors?

Organizational assets and competencies that are difficult for competitors to imitate

**What are competencies?**

- Specific knowledge
- Capabilities
- Innovativeness
- Superior strategies
- Close relationships with suppliers

**Example:**

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<tr>
<th>Company</th>
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<th>Product</th>
<th>Comparative advantage based on</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dell</td>
<td>Global supply chain</td>
<td>PC, laptop</td>
<td>capabilities</td>
</tr>
<tr>
<td>Apple</td>
<td>Technological leadership</td>
<td>Smartphone</td>
<td>innovativeness</td>
</tr>
</tbody>
</table>
Theories of International Trade and Investment

**Classical Theories**
- Mercantilism
- Absolute Advantage Principle
- Comparative Advantage Principle
- Factor Proportions Theory
- International Product Life Cycle Theory
- New Trade Theory

**Contemporary Theories**
- Competitive Advantage of Nations
- Michael Porter’s Diamond Model
- National Industrial Policy

**Firm Internationalization**
- Internationalization Process of the Firm
- Born Globals and International Entrepreneurship

**FDI-Based Explanations**
- Monopolistic Advantage Theory
- Internalization Theory
- Dunning’s Eclectic Paradigm

**Non-FDI-Based Explanations**
- International Collaborative Ventures
- Networks and Relational Assets

**Nation-level Explanations**
- Why do nations trade?

**Firm-level Explanations**
- How can nations enhance their competitive advantage?
- Why and how do firms internationalize?
- How can internationalizing firms gain and sustain competitive advantage?
Theories of International Trade and Investment

Classical Theories
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Why do nations trade?

Nation-level Explanations

Dr. Ilke Kardes
BUSA 3000
1. Mercantilism

- Maximize exports and minimize imports!

- Today: also called neomercantilism
  - The nation should run a trade surplus.

- Supporters of neomercantilism:
  - Labor unions: protect domestic jobs
  - Farmers: keep crop prices high
  - Some manufacturers: rely on exports

- Contra: Neglecting free trade
  - The absence of restrictions to the flow of products and services among nations

1500s, Europe
Trade surplus
2. Absolute Advantage Principle

- Specialize in the production of certain products, export them, and import others!
- An advantage over another nation based on inherited resources
- Considers absolute cost of production
- Being the best at something, e.g., Brazil – coffee; Saudi Arabia – oil
- Contra: Neglecting countries without inherited resources

Example:

<table>
<thead>
<tr>
<th>Unit requires for production</th>
<th>Rice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land A</td>
<td>1</td>
</tr>
<tr>
<td>Land B</td>
<td>6</td>
</tr>
</tbody>
</table>

1776, Adam Smith, Scotland
Inherited resources
Absolute cost of production
An advantage over another nation
3. Comparative Advantage Principle

- Produce the product, which results the lowest opportunity cost and the highest relative efficiency.

  Maximal use of resources with minimum expense.

- Condition:

  - A country is less efficient in the production of all goods compared to other nations.
  - But, it is less inefficient in the production of one particular good among other products within the country.

- Importance: The foundation of international trade.

- Contra: Neglecting the availability of technology maximizing the efficiency in production.

### Unit requires for production

<table>
<thead>
<tr>
<th></th>
<th>Rice</th>
<th>Tea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land A</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Land B</td>
<td>6</td>
<td>3</td>
</tr>
</tbody>
</table>

1817, David Ricardo, UK

Opportunity costs, efficiency
An advantage over another product within the country.
Absolute vs. Comparative Advantage Principles

Video: Absolute vs. comparative advantage

Number of the products manufactured in an hour

Automobile

Textile

Germany

Turkey

Absolute advantage over Turkey

Comparative advantage over the automobile
Early trade theories fail to account for ...

- international transportation costs
- government interventions: imposing protectionism (e.g., tariffs) or investing in certain industries (e.g., via subsidies).
- the service sector
- scale economies and superior business strategies
4. Factor Proportions Theory

- Produce and export products that intensively use relatively abundant factors of production: Labor, capital, land, enterprise
- A per-unit-cost advantage
- Also called “Factor Endowments Theory”

The basic strategy is:

If a certain factor of production (e.g., cost of labor) is low relative to the others (e.g., cost of land and capital), specialize in that sector (e.g., labor-intensive sector in our case).

Example:
- 71% of land area in UK is agricultural. (Source: World Bank 2012)
- The top export goods are pearls, gems, precious metals and coins (18 per cent of total exports in 2014). (Source: Real Business 2014)
The Leontief Paradox

In fact, countries can successfully export products that use less abundant resources.

⇒ Paradox between the predictions using the factor proportions theory and the actual trade flows.

The Leontief Paradox implies that international trade is complex and cannot be fully explained by a single theory.
5. International Product Life Cycle (IPLC) Theory

Start with exporting and later undertake foreign direct investment as the product moves through its life cycle.

The IPLC-Theory illustrates that national advantages do not last forever.

6. New Trade Theory

- The departure point of the theory: The comparative advantage of a country decreases as the similarity of factors of production across nations increases.

- How it is possible that different countries have similar factors of production?
  - Answer: advances in technology & growing international trade and business

- How a country can achieve a superior international performance, even in the absence of comparative advantages?
  - Answer: Creating a cost advantage with increase in output of a product

Economies of scale

- Lower per-unit **fixed** costs: Due to the greater quantity of a good produced, because these costs are shared over a larger number of goods.

- Lower **variable** costs per unit: Due to operational efficiencies and synergies.

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1970, Paul Krugman, U.S. Economies of scales Costs per unit
Key Takeaways: Ch6-Part 1

IB theories are derived from …

**Comparative** advantage: Superior features of a country due to inherited resources or national policies.

**Competitive** advantage: Distinctive competencies of a company.

### Nation-level Explanation of IB - Classical IB theories

1) **Mercantilism**  
Trade surplus

2) **Absolute Advantage Principle**  
Inherited resources, absolute cost of production, an advantage over another nation

3) **Comparative Advantage Principle**  
The relative efficiency, opportunity costs, an advantage over another product within the country

4) **Factor Proportions Theory**  
Per-unit-cost advantage due to abundant factors of production

5) **International Product Life Cycle Theory**  
Outsourcing manufacturing during the product’s life cycle

6) **New Trade Theory**  
Economies of scales, per-unit cost advantage due to the increase in production
IB Theory Timeline

Europe

1500 Mercantilism

1600

1700 A. Smith

Absolute Advantage

D. Ricardo

Comparative Advantage

Scotland

1800

1900 E. Heckscher

Factor Proportions Theory

R. Vernon

International Product Life Cycle

P. Krugman

New Trade Theory

Sweden

1900

2000 M. Porter

U.S.

2000

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