

Chapter 2

Theory of International Trade Theories

Theory of Mercantilism: The theory of mercantilism is an economic theory that was prominent in Europe between the 16th and 18th centuries. The core concept of this theory is the belief that a country's wealth is measured by its ability to accumulate gold and silver. According to mercantilism, a country should focus on exporting more goods than it imports, thereby creating a favorable balance of trade. In order to achieve this, mercantilists believed in government intervention, such as tariffs, subsidies, and other forms of protectionism, to promote domestic industries and limit imports.

- Belief that a country's wealth and power is determined by its accumulation of precious metals, such as gold and silver.
- Assumption that international trade is a zero-sum game, where one country's gain is another's loss.
- Advocates for policies that promote exports and restrict imports to maintain a favorable balance of trade.
- Belief that colonies exist to provide raw materials for the mother country's industries and to serve as markets for their finished products.

Theory of Absolute Advantage: The theory of absolute advantage was developed by Adam Smith, a Scottish economist, in 1776. This theory argues that a country should specialize in producing goods that it can produce more efficiently than other countries, regardless of whether it has an absolute advantage in producing all goods. According to Smith, trade between countries can be mutually beneficial if each country specializes in the production of goods in which it has an absolute advantage and then trades these goods for goods produced by other countries.

- Developed by Adam Smith in his book "The Wealth of Nations."
- Argues that a country should specialize in producing goods that it can produce more efficiently than other countries, based on its absolute productivity.
- Assumes that countries have fixed resources and that production costs are constant.

- Emphasizes the benefits of international trade, as countries can exchange goods and services at lower costs than producing them domestically.

Theory of Competitive Advantage: The theory of competitive advantage was developed by Michael Porter, an American economist, in 1985. This theory argues that a country can achieve economic success by specializing in the production of goods and services that it can produce more efficiently than other countries, and by creating a favorable business environment that attracts investment and encourages innovation. According to Porter, a country's competitive advantage can be based on factors such as skilled labor, access to natural resources, and technological innovation.

- Developed by Michael Porter in his book "The Competitive Advantage of Nations."
- Argues that a country's competitiveness is determined by the quality of its business environment and the ability of its firms to innovate and upgrade their products and processes.
- Assumes that competition drives innovation and productivity improvements, leading to cost reductions and quality improvements.
- Emphasizes the role of government policies, institutions, and clusters in promoting competitiveness.

Theory of Comparative Advantage: The theory of comparative advantage was first developed by David Ricardo, a British economist, in 1817. This theory argues that a country should specialize in producing goods that it can produce at a lower opportunity cost than other countries, even if it does not have an absolute advantage in producing those goods. According to Ricardo, trade between countries can be mutually beneficial if each country specializes in the production of goods in which it has a comparative advantage and then trades these goods for goods produced by other countries.

- Developed by David Ricardo, building on Smith's theory.
- Argues that a country should specialize in producing goods that it can produce relatively more efficiently than other goods, even if it does not have an absolute advantage.
- Assumes that countries have different production costs due to differences in resource endowments, technology, and skills.

- Emphasizes the gains from trade, as countries can benefit by specializing in their comparative advantage goods and trading them for other goods.

Factor Endowment Theory: The factor endowment theory argues that a country's comparative advantage is based on its factor endowments, which include its natural resources, labor force, capital, and technology. According to this theory, countries that are rich in natural resources, such as oil or minerals, will specialize in producing goods that are resource-intensive, while countries with a highly skilled labor force will specialize in producing goods that require skilled labor.

- Developed by Eli Heckscher and Bertil Ohlin.
- Argues that a country's comparative advantage is determined by its factor endowments, such as labor, capital, and natural resources.
- Assumes that different countries have different endowments, leading to different relative prices of goods and factors of production.
- Emphasizes the gains from trade, as countries can benefit by specializing in their abundant factor-intensive goods and trading them for other goods.

Product Life-Cycle Theory: The product life-cycle theory was developed by Raymond Vernon, an American economist, in 1966. This theory argues that a product goes through different stages in its life-cycle, including the introduction, growth, maturity, and decline stages. According to Vernon, a country's comparative advantage in producing a particular product can change over time as the product moves through these stages. For example, a country may have a comparative advantage in producing a new product during the introduction stage, but as the product matures, other countries may develop a comparative advantage in producing it.

- Developed by Raymond Vernon.
- Argues that a country's comparative advantage changes over time as a product goes through different stages of its life cycle, from innovation to maturity to decline.
- Assumes that a country's comparative advantage in a product is initially based on its innovation and technology capabilities, but later shifts to lower-cost production as the product becomes standardized.

- Emphasizes the role of multinational corporations in transferring technology and know-how across countries and regions.

FDI Based Theories

1. **Market Imperfections Theory:** The Market Imperfections Theory of FDI argues that foreign direct investment occurs when firms seek to exploit market imperfections in host countries that are not present in their home countries. These imperfections may include differences in market size, regulatory environment, labor costs, and access to resources.
2. **Eclectic Paradigm Theory:** The Eclectic Paradigm Theory, also known as the OLI model, is a comprehensive theory of FDI developed by John Dunning. It argues that FDI occurs when three conditions are met: ownership advantages, location advantages, and internalization advantages. In other words, a firm must have unique advantages in ownership, location, and internalization to invest in a foreign country.
3. **Product Life Cycle Theory:** The Product Life Cycle Theory of FDI, developed by Raymond Vernon, argues that firms invest in foreign countries to take advantage of differences in the stages of the product life cycle. Specifically, firms invest in countries with lower labor costs during the production phase, and then shift production to higher-wage countries during the maturity and decline phases.
4. **Internalization Theory:** Internalization Theory argues that firms invest in foreign countries to internalize production processes and avoid transaction costs associated with licensing, franchising, or exporting. By investing in foreign production facilities, firms can maintain control over their proprietary technologies and maintain quality control.
5. **Monopolistic Advantage Theory:** The Monopolistic Advantage Theory of FDI, also known as the Market Power Theory, was developed by Stephen Hymer. It argues that firms invest in foreign countries to gain monopolistic advantages, such as proprietary technology, brand recognition, and economies of scale. These advantages allow firms to charge higher prices and earn higher profits in foreign markets than they would in their home countries.
6. **Modified Theories for Third World Firms:** Modified Theories of FDI for Third World Firms focus on the unique challenges faced by firms in

developing countries, such as limited access to capital, technology, and skilled labor. These theories suggest that firms in developing countries invest in foreign markets to overcome these challenges and gain access to new technologies, markets, and resources.

Some examples of modified theories for third world firms include:

- The Bargaining Power Theory, which argues that firms in developing countries invest in foreign markets to gain bargaining power and negotiate better terms with multinational corporations.
- The Export-Led Growth Theory, which argues that firms in developing countries invest in foreign markets to export goods and services and promote economic growth.
- The Technology Gap Theory, which argues that firms in developing countries invest in foreign markets to gain access to new technologies and improve their competitive position in global markets.

Overall, modified theories for third world firms recognize the unique challenges faced by firms in developing countries and suggest that foreign direct investment can be a valuable tool for overcoming these challenges and promoting economic growth.

Implications of International Trade Theories

1. **Specialization:** International trade theory emphasizes the benefits of specialization, which allows countries to focus on producing goods and services in which they have a comparative advantage. This leads to greater efficiency and increased productivity.
2. **Free Trade:** International trade theory also supports the idea of free trade, which allows countries to exchange goods and services without restrictions or barriers. This can lead to increased competition, lower prices, and greater consumer choice.
3. **Interdependence:** International trade theory recognizes the interdependence of countries in the global economy. Countries rely on each other for goods, services, and resources, and this can lead to greater cooperation and collaboration.
4. **Economic Growth:** International trade theory suggests that trade can be a driver of economic growth, as countries can gain access to new markets and resources, and benefit from increased efficiency and productivity.

Implications of International Investment theories

1. **Foreign Direct Investment:** Investment theories suggest that foreign direct investment can be a valuable tool for firms seeking to expand into new markets, access new resources, and gain a competitive advantage. FDI can also lead to increased economic growth and job creation in host countries.
2. **Globalization:** Investment theories also recognize the growing trend of globalization, as firms seek to expand their operations and access new markets around the world. This can lead to greater competition, increased innovation, and greater consumer choice.
3. **Host Country Benefits:** Investment theories suggest that host countries can benefit from foreign investment in a number of ways, including job creation, technology transfer, and increased economic growth.
4. **Risks:** Investment theories also acknowledge the risks associated with foreign investment, such as political instability, regulatory barriers, and currency fluctuations. Firms must carefully consider these risks when making investment decisions.
5. **Market Imperfection:** Market imperfections refer to situations where the market fails to allocate resources efficiently. Investment theories recognize that market imperfections can create opportunities for firms to earn profits through foreign direct investment. For example, if a firm has proprietary technology that is not available in a foreign market, it may be able to earn a higher rate of return by investing in that market and using its technology to gain a competitive advantage.
6. **PLC Advantage:** The Product Life Cycle (PLC) theory suggests that products go through distinct stages over time, including introduction, growth, maturity, and decline. Investment theories recognize that firms can benefit from investing in different stages of the PLC. For example, firms may invest in the introduction stage to establish a foothold in a new market, or in the growth stage to take advantage of increasing demand. Similarly, firms may invest in the decline stage to acquire distressed assets at a discount. The PLC theory has important implications for international investment, as it suggests that firms may need to adjust their investment strategies over time to take advantage of changing market conditions.

Contemporary issues of International Theories

1. **Rising Protectionism:** Despite the benefits of free trade, there has been a rise in protectionism in recent years, as countries seek to protect their domestic

industries from foreign competition. This trend can lead to reduced global trade and economic growth, as well as increased geopolitical tensions.

2. **Digital Economy:** The rise of the digital economy has created new challenges for international trade and investment theories. Digital goods and services can be difficult to regulate, and countries may need to develop new policies and regulations to address these challenges.
3. **Environmental Concerns:** Environmental issues, such as climate change and sustainability, have become increasingly important in international trade and investment. Countries may need to consider the environmental impact of trade and investment policies, and work together to address global environmental challenges.
4. **Income Inequality:** International trade and investment can lead to increased income inequality, as some industries and workers may benefit more than others. This can create social and political tensions, and may require new policies and regulations to address.
5. **Intellectual Property Rights:** Intellectual property rights have become a major issue in international trade and investment, particularly in the digital economy. Countries may need to develop new policies and regulations to protect intellectual property rights and encourage innovation.
6. **Geopolitical Tensions:** Geopolitical tensions, such as trade disputes and conflicts, can create uncertainty and instability in the global economy. International trade and investment theories may need to consider the impact of geopolitical tensions on global trade and economic growth, and develop strategies to mitigate these risks.