International Business

International Trade and Investment Theory

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International Trade and Investment Theory

The leading International Business textbooks either start out on a basis of trade and investment theory, or else come to it within the body of the book at various points. It therefore makes sense to review the main concepts and theories at this early stage. It will give you a sound basis for your international business studies and you will be more likely to provide well-founded responses in the assignments and exercises that you will come across in all following sub-fields.

International trade and investment theory is an essential underpinning of all concepts that you will study in International Business (IB). A great many students resent theory as something 'dry' and uninteresting: in the field of IB, you will find that examples of these theories surround us everyday and everywhere, so they are likely to arouse your interest. Also, thinking of how you are influenced by IB will help you answer exam questions more easily for example: where does your laptop come from? Where does the brand originate from? Where are the components made? Where did you buy it; where do you use it? Why is that so?

International trade is all about exchanging goods and services among foreign economies. It has become an important topic because most economies have changed from a state-driven to a market-driven economic system throughout the past decades. Trade with some economies (countries and regions) in the world is booming, while other economies appear to be less concerned. This is due to the resources and conditions that are sought by engaging in international trade.

International trade is a complex machinery that links trade, economics, management and public policy issues, among others. It influences the national economic indicators of a nation's wealth such as unemployment or inflation. As a consequence, many economists, starting with Adam Smith, the 'father' of economics, have tried to explain the relationship between free trade and economic wealth. International trade and investment theory helps you to:

- understand the traditional arguments of how and why international trade improves the welfare of all countries: why not only trade domestically?
- use history as a basis to learn from, and compare the implications of trade theory from the original work of Adam Smith to the contemporary theories of Michael Porter and further
- examine the criticisms of classical trade theory and examine alternative viewpoints of which business and economic forces determine trade policy between countries, as well as international management decisions
- explore why trade and investment are different and engage economies and business leaders in various evolving strategies.

Trade policies are designed by governments to regulate, direct, and protect national economic activity and welfare. On the basis of national sovereignty, a government exercises the right to shape the environment of the country and its citizens. The main objectives of governmental authorities are to increase their citizens' living standards, improve the quality of life, and to achieve high employment rates. Governmental authorities hence shape the environment in which corporations exercise trade and run investments.

Taking it *Further*

In democratic countries, governmental authorities' interest in economic growth and welfare is stirred by the desire of re-election and mainly maintained through a civil service administration that keeps a long-term focus on its objectives.

If international trade exists nevertheless, there must be good reasons for it that counterbalance or complement the apparent simplicity and advantages of domestic trade. No one single theory explains these factors on its own. Because IB is more complex than domestic trade and has evolved significantly over time, each theory has its own merit and complements earlier findings.

Remember the absolute 'must knows':

- *The age of Mercantilism*
- *Classical Trade Theory: Smith and Ricardo*
- *Factor Proportions Theory*
- *International Investment and Product Cycle Theory*
- *The New Trade Theory: Strategic Trade*
- *The Theory of International Investment*

Mercantilism: 16th to 18th Centuries

Mercantilism has given one of the first clues to the interrogation of why nations trade with one another, at a time when gold was the world currency (18th century). European nations suggested that their wealth would be accelerated when exports were encouraged and imports stifled in order to reach a *positive trade balance.* The currency would hence flow into the economy. As a consequence, it was argued that the more gold that was accumulated in the country, the more powerful it was to be.

Mercantilism does not focus on specialization but concentrates on policy. Some economies, such as the French nationalizations in the 1970s/80s, and China in the early 2000s, showed a trend towards mercantilist policies.

The Theory of Absolute Advantage: Adam Smith

The theory of *absolute advantage* is the starting point for an explanation of international trade through the specialization lens. It was developed by Adam Smith, a Scottish economist, philosopher and author of *The Wealth of Nations* (1776).

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By specializing in the production of goods that an economy can produce more efficiently than any other, he stated, nations can increase their economic well-being.

The productivity approach is the key factor in economic development Country X has an absolute advantage over Country Y when it is able to produce the same good faster, better; cheaper (we only speak of efficient production here). Countries will export the goods produced with the lowest labour-hours needed. Country X which has an absolute advantage on certain goods will have to export those goods and import the goods that it is lacking. Country Y holds the absolute advantage for another good. The two countries will engage into trade relations to a mutual benefit.

Following this theory, one can assume that countries try to maximise the use of their natural resources in order to manufacture the same products with fewer labour-hours than competitors in other countries. But, in order to be efficient, the production process must be performed exclusively by one individual actor in each stage. It creates a division of labour. Each country specializes in one product (or service, if we extend this theory) for which it is uniquely suitable. With his works, Adam Smith hence advocated free trade and pioneered modern economics.

At that time, the value of a product was determined by its use or by what it could acquire in exchange, both of which were inconsistent standards of measurement, according to Smith. Instead, he argued that value should depend on another factor.

> "Labour was the first price, the original purchase – money that was paid for all things. It was not by gold or by silver, but by labour, that all wealth of the world was originally purchased."
>
> (*The Wealth of Nations*, Adam Smith, 1776)

For Smith, this factor was mainly that of labour, in the early stages of socio-economic evolution. At the same time, he explored concepts of self-interest and its role in the economy, the division of labour, the function of markets, and the international implications of a *laissez-faire* economy.

Following Adam Smith's work, self-interest appeared to stimulate the efficient use of resources in a nation's economy (the Invisible Hand), of public welfare as a by-product, and of market forces.

> "it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."
>
> (*The Wealth of Nations*, Adam Smith, 1776)

Remember that as a main merit, this theory stipulates that gains from international trade can be created. These gains can be enhanced through further specialization, but cannot be evenly distributed in the domestic economy because not all actors specialize in the relevant good and production.

The labour theory of value prevailed among classical economists in the mid-19th century. It mainly found its expression in Marxian economics. Today, the theory of marginal utility replaces it: a good or service holds its utility (use) in its least urgent use of the most desired available uses, i.e. the use that is right in the margin that may vary for individuals and

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companies.

The Theory of Comparative Advantage: David Ricardo

The Theory of Comparative Advantage demonstrates that gains from international trade also persist when both countries excel in the production of two of the same goods, and trade with each other. David Ricardo, an English-born economist sparked by the reading of Smith's *Wealth of Nations*, worked upon the concept of the division of labour and its equilibrium through the mechanism of relative prices. The theory, elaborated in the early 19th century, holds that nations should produce the goods excelling through the greatest *relative* advantage.

In the example of Portugal and England and two commodities (wine and cloth), trade was to be beneficial even if Portugal held an absolute cost advantage over England in both wine and cloth. Because each economy specializes in the production of the good in which it has a comparative cost advantage and trades with the other nation for the other good, both nations are able to benefit from the exchange. Ricardo argued at the same time that factors, particularly labour, are not mobile across borders. Economic growth and wealth are increased if goods (excluding luxuries) are imported at a lower price than they cost domestically. Overall income levels would rise in both nations because domestic industry can concentrate on more advantageous goods, according to factor advantages, creating efficiencies, providing labour and increasing purchasing powers.

According to Ricardo's theory, countries trade on a win-win basis, exchanging their specialized production. That is the consequence of differences between production techniques, capital and labour and productivity.

For olive oil (100 litres) and pasta (50 kg), Spain may need respectively one and three hours for production, while Italy may use five and seven hours. According to Adam Smith, Spain has an absolute advantage over Italy regarding olive oil and pasta production since it manufactures both products within fewer hours than Italy. As a consequence, one can understand why Spain will export olive oil and pasta to Italy. Using Ricardo's theory, Spain owns a larger relative advantage (1/5) regarding olive oil production than pasta production (3/7). In this case, one can understand that Spain will produce and export olive oil. Italy, with a larger relative advantage in pasta production (7/3) than olive oil (5/1) will produce and export pasta.

Extensions of Ricardo's Work: Karl Marx

Some main contributions and extensions of Ricardo's work were made by John Stuart Mill (1848) and Karl Marx (1867–94). The latter, among his works, confirmed the relation established by Ricardo between labour and value; for Marx, the value of a product is based on the labour used for its production (a variable capital) and capital (as a constant capital). The value of a commodity is the socially necessary labour time embodied.

Another Extension: The Theory of the International Values – John Stuart Mill

John Stuart Mill, a liberal British philosopher and economist of the 19th century, advocated, among others, the use of economic theory in political decision-making. In this theory of international values, Mill clarifies the mechanisms for fixing the terms for exchanges. He explains that when products of one country are exchanged with products of another, the value of the exports should be equal to the value of the imports. This work was hence exploring the law of international values in terms of reciprocal demands of countries for each other's products.

The Theory of Factor Proportions: Eli Heckscher and Bertil Ohlin

In 1933, the Swedish academics Heckscher and Ohlin explain international trade by the abundance or rarity of factors of production. They in particular expand the number of factors of production to two, i.e. labour and capital, and explore the variations of these factors across industries, economies and international trade, in their ratio.

Remember Heckscher and Ohlin for their model that relates two factors of production: 'labour' and 'capital'.

The two economists considered that different goods required different proportions of these two factors of production. The price of these factors then determines cost differences and these prices are determined by the endowments of labour and capital the country has. The Factor Proportions Theory argues for a country to specialize in the production and export of those products for which it uses intensively its relatively abundant factor. This implies that a relatively capital abundant country must ideally specialize in the production of capital-intensive goods and should export these goods in exchange for labour-intensive goods that would come from a relatively labour-abundant country. One important condition here is that the markets for the inputs and the outputs are perfectly competitive. The theory holds only when both countries use identical technologies, while the earlier Ricardian model assumed that production technologies differ.

Pitfall

Watch out for a typical question that you may be asked in class and that goes as follows (or similar): If China excels in leather footwear manufacturing and the USA in computer memory chips, how should the two countries specialize in production in accordance with these goods? With the Heckscher-Ohlin model, you are well-advised to argue that the manufacturing of leather footwear is still a relatively labour-intensive process, even with the most sophisticated leather treatment. Other goods, such as computer memory chips, although requiring some highly skilled labour, require massive quantities of capital for production.

The H-O model, later extended by Samuelson and Vanek, among others, shows that international trade will occur, as nationally advantageous. It has quantifiable effects upon prices, wages and rents, because of relative factor endowment differences between trading nations, and when different industries use factors in varying proportions.

> "… there have been many theories regarding international trade from Smith to now. Each of these theories has turned to be a starting point for more understanding. For instance, Ricardo's comparative advantage is the evolution of Smith's absolute advantage theory, the following Leontief's paradox is an evolution of Heckcher and Ohlin theory… Each time we realise that a theory cannot really apply entirely to the real world, another theory is needed."
>
> ('Funeral by funeral, theory advances'. Paul Samuelson)

The Leontief Paradox: Wassily Leontief

Leontief, an American economist of Russian origin, and Nobel Prize winner for economic sciences in 1973, established the famous Leontief paradox. He was particularly known for his work in qualitative economics, through input-output analysis. Based on the theory of factor proportions, Leontief studied American trade and expected exports of strongly capitalized products and imports of products that required a large amount of labour. By his study in 1947–53, he had put in evidence of the specialization of the USA in labour-intensive products instead of capital-intensive ones, which was surprising. It counters the theory of factor proportions. With this, Leontief showed the importance of clarifying the quality of the factors of production by taking into consideration the particular characteristics of each co-exchanger's countries.

The H-O theory predicted that countries would export the products that use their abundant factors intensively. In 1947, Wassily Leontief tested whether the factor proportions theory could be used to explain the types of goods the USA imported and exported.

Leontief's contribution to international trade is the understanding that one theory alone cannot explain the phenomenon and that one needs to complement the factor proportions theory of international trade.

The Product Life Cycle Theory: Raymond Vernon

The American economist R. Vernon shed light on international trade mechanisms with a focus on the cycle of life of a product. It helped explain how and at what stage firms move their products and innovations through international markets. Studying the nature of innovation in the USA and firm strategy for the product in question, he observed four phases in a product's life cycle:

- Stage 1: *the new product.* The product requires highly skilled labour and large quantities of capital for research and development. It is only a prototype (meaning non-standardized) and is extremely expensive. The product is made and sold only in the innovative country.
- Stage 2: *the maturing product.* The product becomes standardized, all the production fees decline, economies of scale are made, and the product is exported to other developed, high-income countries.

- Stage 3: *the standardized product.* The mature product. It is being bought by all kinds of populations and the market is saturated. There is development of ranges around the product.
- Stage 4: *the decline.* The product becomes obsolete and its technology is old-fashioned. There is less interest in the product.

An oft-cited, pertinent example of this theory is the product life cycle of photocopiers. Photocopiers were developed in the early 1960s by Xerox in the USA. At first, Xerox exported photocopiers from the USA to other advanced countries. As demand began to grow in these countries, Xerox entered into joint ventures to set up production in Japan, called Fuji-Xerox, and Great Britain, called Rank-Xerox. Once Xerox's patents expired, other foreign competitors began to enter the market. As a consequence, exports from the USA declined, and users began to buy photocopiers from lower-cost foreign sources, such as from Japan. More recently, Japanese companies found that their own country was too expensive to manufacture photocopiers, so they began to switch production to developing countries such as Singapore and Thailand, and to add more innovation.

Economies of Scale, the New Trade Theory and Network Theory

In the 1970s and the 1980s, the New Trade Theory challenges and extends classical economic models for international trade. You will study extensions of international trade theory that were made ever since, by, among others, the American economist Paul Krugman. He suggested in the 1990s that trade reflects an overlay of increasing-returns specialization on comparative advantage in the frame of *monopolistic competition.* Formerly, increasing returns were only thought to alter the pattern of comparative advantage. Important firms are recognized as being able to obtain great scale benefits and low cost per unit, called *Economies of Scale;* thus a firm holding international economies of scale can potentially monopolize an industry and create an imperfect market. According to Krugman, a firm should produce the volume necessary for economies of scale – cost benefits and other firms in other countries may produce products that are similar in order to exchange them. Similar products are then substitutable for the consumer, with the same process of production for the producer. Staffan Burenstam Linder's Overlapping Product Ranges Theory explained that trade in manufactured goods is dictated by similarities in product demands across countries, not by cost concerns. He introduced the network effects of consumption (resulting in market segments).

> "Globalization, like the telephone, is both a blessing and a curse… Globalization is like a giant wave that can either capsize nations or carry them forward on its crest…"
>
> "… Yet, only 30 countries share 56% of the world GDP and 72% of trade flows. This implies that only a minority of countries take advantage of the Smithonian and Ricardian trade aspirations. Today, the large majority of countries do not take part in the gains of international trade."
>
> (Joseph E. Stiglitz)

Michael Porter's Diamond

Harvard Professor Michael Porter specialized in competitive strategy and the competitiveness of economic development, examined the competitiveness of industries on a global basis and

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contributed the so-called *Diamond of National Advantage* to our understanding of international trade. In this model, in diamond shape, innovation is what drives and sustains competitiveness. Four components define competition that are factor conditions, demand conditions, related and supporting industries, and firm strategy, structure, and rivalry. Knowing and mastering these forces helps the firm to obtain or maintain its competitive advantage through an adapted *value chain.* Porter adds that Competitive Clusters create a critical mass of unexpected competitive success in specific fields, located in one place based on public-private initiatives.

The Theory of International Investment

This theory, developed through the recognition of globalizations' effects upon firm behaviour that exceed simple trade relations (exports and imports), illustrates that the movement of capital has allowed foreign direct investments across the globe. Firms have evolved into ‘seekers’, seeking resources, factor advantages, knowledge, security and markets. Also, firms are seen as exploiters of imperfections in access, factor mobility, management, and internalizers that establish their own multinational operations and internalize production.

Note: The firms' competitive advantage is hence strongly dependent on confidentiality.

Indeed, the classical theories were thought to be insufficient to explain modern globalization effects, economies of scale, currency crises, network effects, with the perfect competition less realistic than, for example, the assumptions made by *monopolistic competition*. When a monopolistically competitive market expands, a mixture of more firms (greater product variety) and bigger firms drives with bigger scale economies. Liberal trade hence expands market size across borders, to the benefit of firms and consumers.

Recommended Reading

RUGMAN AND COLLINSON (2006), *Chapter 6*

CZINKOTA ET AL. (2007), *Chapter 5*

PUNNETT AND RICKS (1998), *Chapter 3*

HILL (2008), *Chapter 4*

- absolute advantage
- leontief paradox
- international trade
- new trade theory
- comparative advantage
- exports
- trade

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