

# THE THEORIES OF INTERNATIONAL TRADE AND INVESTMENT

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# LECTURE OBJECTIVES

Describe and interpret the following theories of international trade and investment:

- Mercantilism;
- Classical theories;
- Factor proportion theory;
- Product life cycle theory;
- Strategic trade theory; and
- Theory of international investment

# THE BASIC QUESTIONS

*Czinkota et.al have seen the following questions dominating this intellectual adventure:*

- Why do countries trade?
- Do countries trade or do firms trade?
- Do the elements that give rise to the competitiveness of a firm, an industry, or a country as a whole, arise from some inherent endowment of the country itself, or do they change with time and circumstance?
- Once identified, can these sources of competitiveness be manipulated or managed by firms or governments to the benefit of the traders?

# MERCANTILISM

- A country involves in trade because it does not meet its all of the needs internally
- Countries and merchants put high value on precious metal 'gold' in order to ensure their capability of buying things
- Mercantilism is the political and economic policy in the seventeenth and early eighteenth centuries aimed at increasing a nation's wealth and power by encouraging the export of goods in return for gold.
- It is believed that there is strength with the accumulation of specie 'gold and silver'
- Mercantilism believes on the policy of exports dominating imports

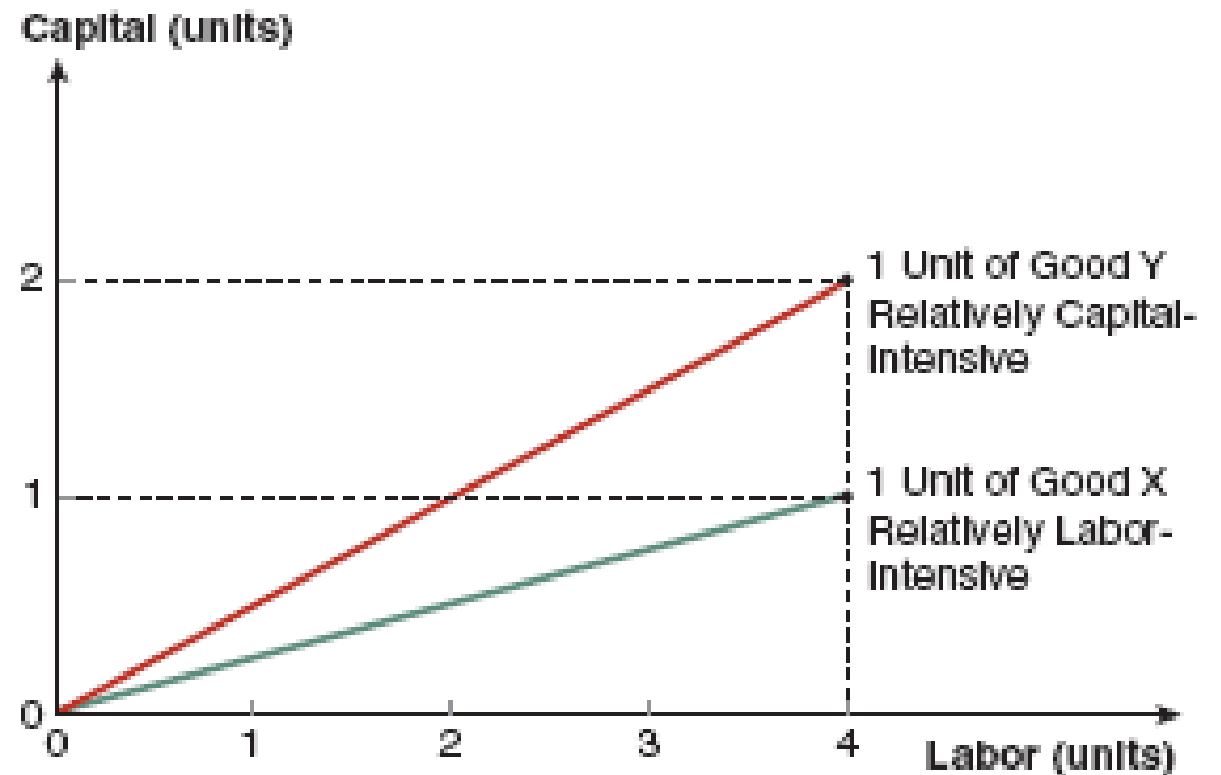
# CLASSICAL TRADE THEORIES

**The theory of absolute advantage** (Adam Smith, 1723-1790): each country should specialize in the production and export of that good which it produces most efficiently- that is, with the fewest labor-hours. Absolute advantage is the ability to produce a good or service more efficiently than it can be produced elsewhere.

**The theory of comparative advantage** (David Ricardo, 1772-1823): Even if one country was most efficient in the production of two products, it must be relatively more efficient in the production of one good. It should then specialize in the production and export of that good in exchange for the importation of the other good. Comparative advantage is the ability to produce a good or service more cheaply, relative to other goods and services, than is possible in other countries.

# FACTOR PROPORTION THEORY (ELI HECKSCHER & BERIL OHLIN)

- A country that is relatively labor abundant (capital abundant) should specialize in the production and export of that product which is relatively labor intensive (capital intensive).
- Factors of production refers all the inputs into production process including capital, labor, land, and technology.



# PRODUCT CYCLE THEORY (RAYMOND VERNON)

Production and consumption of a product need to be based on its stages of development as:

**Stage I-** The new product: it requires highly skilled labor and large scale of capital investment. Its production consumption primarily is based in the innovating countries.

**State II-** The maturing product: product becomes increasingly standardized, the innovating country increases its sales to other countries. Competition is slightly developing.

**Stage III-** The standardized product: the product is completely standardized, profit margins are thin, and severe competition is expected. Expansion of market and production facilities to developing countries is desired

# STRATEGIC TRADE THEORY (PAUL KRUGMAN; MICHAEL PORTER)

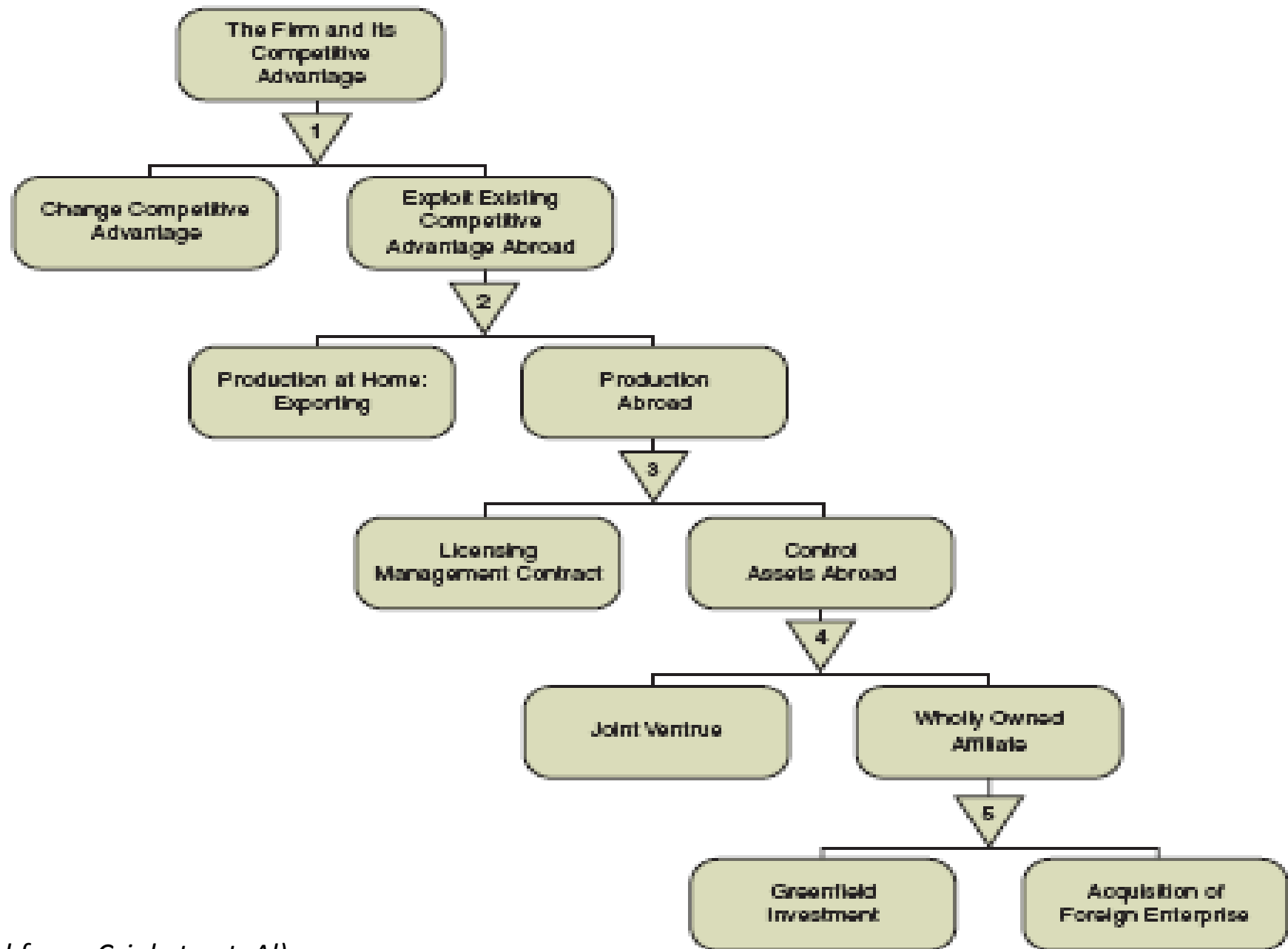
**Paul Krugman:** Trade is altered if market is not perfectly competitive, or when production of specific products possesses economies of scales-internal and external. With internal economies of scale, the larger the firm the greater the scale benefits, and the lower the cost per unit. In case of external economies, when the cost per unit of output depends on the size of an industry, not the size of the individual firm, the industry of that country may produce at lower costs than the same industry that is smaller in size in other countries.

**Michael Porter:** National prosperity is created, not inherited. Innovation is what drives and sustains competitiveness. The factor conditions, demand conditions, related and supporting industries, and firm's strategy, structure and rivalry are four major components (known as Porter's diamond) of national advantages.

# THEORY OF INTERNATIONAL INVESTMENT

- It is a firm (not a country) and a buyer (not a country) that are the subjects of trade, domestically or internationally.
- Investment decisions are influenced by the host country policies
- There are numerous pressure groups like environmentalists, human and animal right activists, philanthropists, and others influencing international investment decisions.
- Imperfections like imperfections in access, imperfection in factor mobility, imperfection in management are influencing the resources exploitations
- Intention behind international expansion varies as: seeking resources, seeking factor advantage, seeking knowledge, seeking security, and seeking markets
- Foreign Direct Investment decisions follows a series of actions and initiatives; it is based on the pluralistic assumptions of all the stakeholders

# FDI DECISION SEQUENCE



*(Adopted from: Czinkota et. Al)*

# ASSIGNMENT AND EXERCISE

Discuss the merits and demerits of following theories of international trade and investment:

- Mercantilism;
- The theory of absolute advantage
- The theory of comparative advantage
- Factor proportion theory;
- Product life cycle theory;
- Strategic trade theory; and
- Theory of international investment

# SELECTED READINGS

**Chapter 3:** Czinkota, M. R., Ronkainen, I. A., & Moffett, M. H. (2011). *International Business*. Hoboken, NJ: John Wiley & Sons.