International Financial Accounting and Policy

International Trade Theory

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Theories on International Trade - Mercantilism (1500- 1800)

Ø Theory - Mercantilism (1500 - 1800)

- Associated with the writings of British & European economists. The aim was to make the new states politically & militarily strong.
- Aiming at a favourable trade balance or a trade surplus (X > M) i.e. promote exports & restrict imports.
- Trade surplus gives economic power which leads to political power. The Mercantilist view was that:
- A country's wealth consisted of its stock of precious metals; a trade surplus leads to an inflow of gold & makes it wealthy

Ø Critique

- Mercantilist view was that one country's gain through trade is at the expense of the other. I/ trade, however, is not a zero sum game.
- When there is a trade surplus, the inflow of gold will lead to an increase in money supply. This leads to a rise in prices making Britain's exports uncompetitive in the next round.

Principle of Absolute Advantage (Adam Smith- 1776)

- If 1 unit of output can be produced in country A with less labour than in country B (or if 1 unit of labour produces more units of output in country A than in B), then A has an absolute advantage over B in producing that commodity.

- Suppose one worker can produce during a given time period

Country	Wheat (Units)	Cloth (Units)
A	4	2
B	2	4

- A is absolutely superior to B in producing wheat
- B is absolutely superior to A in producing cloth
- Therefore, specialize & trade according to the principle of AA

Principle of Absolute Advantage Illustration

- Suppose countries A&B have 100 workers each & their productivity is as stated previously; w/o trade, each country will employ half its workforce to produce each of the commodities - wheat & cloth

- **Position without specialization & trade:**

- **Position with specialization & trade:**

- Thus, total world output (& wealth) has increased

Principle of Comparative Advantage (David Ricardo - 1817)

Ø If country A can produce a good at a lower opp. cost than country B in terms of other goods forgone, then A has a comparative advantage over B in producing that good. Suppose 1 worker can produce:

Country	Wheat (Units)	Cloth (Units)
A	8	4
B	1	2

Principle of Comparative Advantage Illustration

Ø In the above example, let Terms of Trade be: 1 unit of wheat = 1 unit of cloth

ü Earlier, for 8 units wheat, A can get only 4 units cloth by her own efforts. Now, A can get 8 units of cloth.

ü With respect to country B, for 2 units cloth she can get only 1 unit of wheat by her own efforts. Now, B can get 2 units of wheat.

ü The lesson is: a country should specialize in producing that good where the absolute advantage is highest or absolute disadvantage is lowest.

Comparative Advantage Principle Expressed in Money Prices

Nation	Labour	Wage/ hour	**Cloth** Qty	**(Yards)** Price	**Wine** Qty	**(Bottles)** Price
USA	1 hour	$ 20	40	$ 0.50	40	$ 0.50
UK	1 hour	£ 5	10	£ 0.50	20	£ 0.25
UK	1 hour	$ 8	10	$ 0.80	20	$0.40

- Ø Assume that Exchange Rate : $ 1.60 = £ 1

Ricardo's Theory - A Critique

i. Labour was the only factor of production considered by Ricardo. Capital, as a factor of production was ignored.

ii. Labour is mobile between industries within a country but immobile between countries. Only goods made by labor move

iii. It is a supply side theory. The demand side (importance of customer preferences) in determining price was overlooked.

iv. It did not explain the basis of differences in labour productivity.

v. A static theory. It was not realized that comparative advantage can change over time.

vi. Simplifying assumptions: - 2 countries x 2 commodities x 1 factor of production (labour)

vii. Free trade & no barriers to trade are assumed

Benefits of International Trade

i. Bigger output with specialization & a more efficient use of resources world- wide.

ii. Better quality with specialization & competition

iii. A wider variety of goods & access increases consumer welfare.

iv. Larger market – can gain economies of scale, leading to lower unit cost & price to consumer

v. Survival (a country may be rich in minerals, but lack cultivable land to grow food for its people.

vi. With I/ trade a country can reach its Productivity

vii. International trade is an "engine of growth"

Trade model Extensions & Applications Heckscher- Ohlin's Factor Endowment Theory - 1933

- Ricardo did not explain what determined comparative cost advantage; but, H-O theory explains why comparative costs differ between countries.
- In order to produce a good, different combinations of labour & capital (factor proportions) must be used.
- H-O theory states that different countries have different resource endowments (labour & capital). A country will produce & export goods that make more intensive use of its abundant resource. According to H-O theory, it is the difference in relative factor endowments (& not labour productivity) that determines the pattern of international trade.

Leontief Paradox (1954)

- USA is a relatively capital- rich, but a labor- scarce country
- On H-O theory, USA should export capital- intensive goods & import labour- intensive goods
- Leontief analyzed the capital : labour ratios for 200 US export industries & import-competing industries
- He found that US exports were less capital- intensive than US imports (Leontief Paradox)
- It is perhaps explained by the fact that US exports products using high technology & skilled labour (computer software) rather than large amounts of physical capital (machinery).

Product Life Cycle Theory (Vernon - 1966)

- **Stage 1- New product stage**
  - ü A new product is developed (e.g. in USA – TV's, photocopiers, instant cameras)
  - ü It caters to the high income (affluent) class
  - ü At first, production & consumption is limited to US market
- **Stage 2- Maturing product stage**
  - ü Production process gets standardized, mass production & economies of scale.
  - ü Exports go to other countries e.g. W. Europe
  - ü US producers might locate plants overseas & start manufacturing abroad e.g. in W. Europe
  - ü US industry loses its competitive advantage
- **Stage 3-Standardized product stage**
  - ü Production process is mastered by other nations
  - ü Production also shifts to developing nations (East Asia) due to low cost
  - ü USA & EU may now import the product from developing countries. It is dynamic comparative advantage i.e. from USA, the advantage shifts to other Developed Countries & then to developing countries (garments, electrical & electronic items).

Porter's Diamond of National Competitiveness (1990)

- To succeed in a competitive market, a firm must develop a basis of sustainable competitive advantage.
- This could be based either on low cost or differentiation

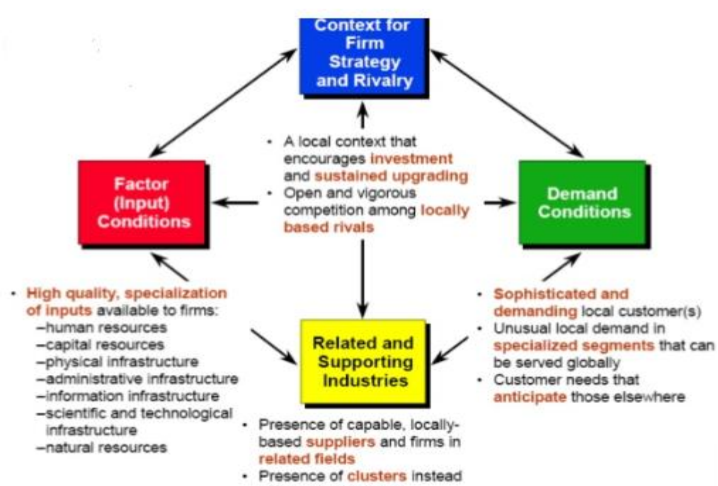
- Cost leadership = deliver same value at a lower price
- Differentiation = deliver more benefits to customer & be rewarded with a higher price

- Competitiveness of a national industry can be evaluated through Porter's concept of the Diamond

- It has 4 inter- related facets, which have a symbiotic relationship; each facet reinforces the other viz.
  - ü Factor conditions
  - ü Demand conditions,
  - ü Firm's strategy, structure & rivalry
  - ü Related & supporting industries.

  - ü An industry that is strong in all 4 facets is globally competitive

Porter's Diamond Model (1990)



Broad Implications for Business

- **Location Implications:**
- A firm can disperse production activities to countries where they can be performed most efficiently

- **First mover implications:**
- Invest substantial financial resources in building a first-mover, or early mover advantage

- **Policy implications:**
- Promoting free trade is in the best interests of the home-country, but not always in the best interests of the firm