CHAPTER 3: INTERNATIONAL TRADE & INVESTMENT THEORY

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1. INTRODUCTION
1.1 TRADE DEFINITIONS

- Trade is the **voluntary exchange** of goods, services, assets, or money **between person or organization and another**. Trade will only be **complete** if both **parties** of the transaction believe that they will **gain** from the voluntary exchange.

- **International trade**- **voluntary exchange** of goods, services or assets between residents(individuals or organizations) of **two countries**.
2. CLASSICAL COUNTRY-BASED THEORIES
2.1 MERCANTILISM

- A country’s wealth, usually measured by its holding of gold and silver, should be accumulated by encouraging exports and discouraging imports.
- Practices by - Britain, France, Netherlands, Portugal, and Spain.
- Neomercantilists/protectionists - Modern supporters of mercantilism; claim that a country should create trade barriers to protect its industries from foreign competition.
2.2 ABSOLUTE ADVANTAGE

- Introduced by Adam Smith
- “A country should specialize in production and export of goods which it produce most efficiently, that is with the fewest labour hours”
## Example of AA theory:

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>RICE (1 TON)</th>
<th>PALM OIL (1 TON)</th>
</tr>
</thead>
<tbody>
<tr>
<td>THAILAND</td>
<td>1 WORKER</td>
<td>5 WORKERS</td>
</tr>
<tr>
<td>MALAYSIA</td>
<td>6 WORKERS</td>
<td>3 WORKERS</td>
</tr>
</tbody>
</table>

Uses 1 worker to produce 1 ton of rice - more efficient in rice production

Uses 3 workers to produce 1 ton of palm oil - more efficient in palm oil production
2.3 COMPARATIVE ADVANTAGE

- Developed by David Ricardo
- “If one country (in a 2-country world) held absolute advantages in production of both products specialization and trade could still benefit both countries”
Example of CA theory:

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Thailand produces 1 ton of rice and 1 ton of palm oil more efficiently than Malaysia, but is more efficient to let Malaysia produce palm oil (since Malaysia produces palm oil better than rice) rather than producing both commodities.
2.4 RELATIVE FACTOR ENDOWMENT (FACTOR PROPORTIONS THEORY)

- By Eli Heckscher and Bertil Ohlin
- Focusing on resources
- “Countries produce and export goods that require resources (factors) that are abundant and import goods that require resources in short supply”
- Basic considerations:
  - Factor endowments (or type of resources vary among countries)
  - Goods differ according to the types of factors that are used to produce them
3. MODERN FIRM-BASED THEORIES
3.1 COUNTRY SIMILARITY THEORY

- Inter industry trade - exchange of goods produced by one industry in country A for goods produced in country B. Eg: Exchange of Thai rice and Msian palm oil

- Intra industry trade - Trade between two countries of goods produced by the same industry. Eg: Exchange of Japanese rice and Thai rice

- “Most trade in manufactured goods should be between similar per capita incomes and intra-industry trade in manufactured goods should be common”
3.2 PRODUCT LIFE CYCLE THEORY

- “International product life cycle consists of 3 stages; new product, maturing product, and standardized product”
- Depends on type of countries—innovating firms country, industrialized countries, less developed countries

**STAGE 1 - NEW PRODUCT**
- High purchase power + demand > new product concept
- Low production because uncertain level of market size
- Most output is sold in the domestic market

**STAGE 2 - MATURING PRODUCT**
- Domestic market became fully aware
- Demand rises
- Higher international sales rather than domestic sales

**STAGE 3 - STANDARDIZED PRODUCT**
- Competition from other companies
- Search for low cost production base
- Demand decreases
4. INTERNATIONAL INVESTMENT THEORIES
4.1 INTERNATIONAL INVESTMENTS

- Two categories:
  - Portfolio investments - passive holdings of securities such as foreign stocks, bonds, or other financial assets, none of which entails active management or control of the securities’ issuer by the investor.
  - Foreign Direct Investment (FDI) - Acquisition of foreign assets for the purpose of controlling them.
4.2 THEORIES

- **OWNERSHIP ADVANTAGE THEORY**
  - “A firm owning a valuable asset that creates a competitive advantage domestically can use that advantage to penetrate foreign markets through FDI”
  - Eg: Intel(Technology)
INTERNALIZATION THEORY

- Explains why a firm would choose to enter a foreign market via FDI rather than exploit its ownership advantages
- Transaction costs- costs of entering into transaction(negotiating, monitoring and enforcing a contract)
- Eg: Honda
ECLECTIC THEORY

FDI will occur when 3 conditions are satisfied:

**OWNERSHIP ADVANTAGE**
- A firm must own some unique competitive advantage that overcomes competitions
- Eg: Brand name

**LOCATION ADVANTAGE**
- Business should be done in a more profitable foreign location than a domestic one
- Eg: Labour, raw materials

**INTERNALIZATION ADVANTAGE**
- The firm must benefit more from controlling foreign business activity rather than hiring other local companies to provide service
- Eg: Hiring locals
4.3 FACTORS INFLUENCING FDI

**SUPPLY FACTORS**
- Firms undertake FDI to lower production costs
- Logistics
- Natural Resources
- Key Technology

**DEMAND FACTORS**
- Customer Access
- Marketing Advantages
- Exploitation of competitive advantages
- Customer Mobility

**POLITICAL FACTORS**
- Firms may invest to avoid trade barriers or take advantage of economic development initiatives
- Avoidance of trade barriers
- Economic development initiatives