I'm currently taking International Business as part of my MBA program at Rutgers, and decided to share my outline for what I'm studying at the moment – international trade theory. These notes are a combination of my own interpretation of the materials presented in “International Business” by Charles W. L. Hill, and direct quotes from that text (which I did not explicitly demarcate). Assume all thoughts and ideas presented here are Hill’s.

1. Mercantilism
   - 1630, Thomas Mun: “…to increase our wealth…sell more to strangers yearly than we consume of theirs in value”

2. Absolute Advantage
   - 1776, Adam Smith. A country has an absolute advantage in the production of a product when it is more efficient than any other country in producing it
   - If two countries specialize in production of different products (in which each has an absolute advantage) and trade with each other, both countries will have more of both products available to them for consumption

3. Comparative Advantage
   - 1817, David Ricardo - Even if one country has an absolute advantage in producing two products over another country, trading with that other country will still yield more output for both countries than if the more efficient producer did everything for themselves.
   - The country with the absolute advantage in producing both products would still produce both products, but less of the one they would trade for, allowing them to essentially allocate more resources to producing the product that they’re comparatively most efficient at producing.
   - Assumes many things:
     o Only 2 countries and 2 goods
     o No transportation costs
     o No price differences for resources in both countries
     o Resources can move freely from producing one product to producing another product
     o Constant returns to scale
     o Fixed stock of resources
     o Free trade does not affect production efficiency
     o No effects of trade on income distribution within a country
   - There are some descriptions of potential outcomes of relaxing some of these assumptions, but I'll leave this as a thought exercise for you, the reader

4. Heckscher-Ohlin Theory
   - 1919, Eli Heckscher and 1933, Bertil Ohlin – Comparative advantage arises from differences in national factor endowments, such as land, labor, or capital, as opposed to Ricardo’s theory which stresses productivity
• 1953, Wassily Leontief – The Leontief Paradox – theorized that since the U.S. has abundant capital compared to other nations, they would export capital-intensive goods and import labor-intensive goods. Data showed that was not the case.
• Therefore, Ricardo's theory seemed to be more predictive.
• However, controlling for technological differences (e.g. eliminating them) does yield a predictive model based on factor endowments

5. The Product Life-Cycle Theory
• 1960's, Raymond Vernon – attempts to explain global trade patterns. First, new products are introduced in the United States. Then, as demand grows in the U.S., it also appears in other developed nations, to which the U.S. exports. Then, other developed nations begin to produce the product as well, thus causing U.S. companies to set up production in those countries as well, and limiting exports from the U.S. Then, it all happens again, but this time production comes online in developed nations. Ultimately, the U.S. becomes an importer of the product that was initially introduced within its borders.
• Weakness – Not all new products are created in the United States. Many come from other countries first, such as video game consoles from Japan, new wireless phones from Europe, etc. Several new products are introduced in several developed countries simultaneously

6. New Trade Theory
• 1970's – Via the achievement of economies of scale, trade can increase the variety of goods available to consumers and decrease the average cost of those goods. Further, the ability to capture economies of scale before anyone else is an important first-mover advantage.
• Nations may benefit from trade even when they do not differ in resource endowments or technology
• Example – If two nations both want sports cars and minivans, but neither can produce them at a low enough price within their own national markets, trade can allow each to focus on one product, allowing for the achievement of economies of scale that will increase the variety of products in both countries at low enough prices
• Example – Airbus spent $14 billion to develop a new super-jumbo jet. Demand is estimated at 400-600 units over the next 20 years, and Airbus will need to sell at least 250 of them to become profitable in this line of business. Boeing estimates the demand to be much lower, and has chosen not to compete. Airbus will have the first mover advantage in this market, and may never see competition in this market segment.
• New trade theory is not at odds with Comparative Advantage, since it identifies first mover advantage as an important source of comparative advantage
• Debate – should government provide subsidies that spawn industries such that companies can gain first mover advantages? Later chapter (and blog post) covers this.

7. National Competitive Advantage – Porter’s Diamond
• 1990, Michael Porter – seeks to answer the question of why a nation achieves international success in a particular industry. Based on four attributes:
  o Factor endowments
    ▪ Basic factors – natural resources, climate, location, demographics
    ▪ Advanced factors – communication infrastructure, sophisticated and skilled labor, research facilities, and technological know-how
    ▪ Advanced factors are a product of investment by individuals, companies, and governments
    ▪ Porter argues that advanced factors are the most significant for competitive advantage
  o Demand conditions – if customers at home are sophisticated and demanding, companies will have to produce innovative, high quality products early, which leads to competitive advantage
  o Relating and supporting industries – If suppliers or related industries exist in the home country that are themselves internationally competitive, this can result in competitive advantage in the new industry.
  o Firm strategy, structure, and rivalry
    ▪ Different nations are characterized by different management ideologies, which can either help or hurt them in building competitive advantage
    ▪ If there is a strong domestic rivalry, it helps to create improved efficiency, making those firms better international competitors
• Porter also notes that chance (such as new breakthrough innovations) and government policies (such as regulation, investments in education, etc.) can influence the “national diamond”

International trade theories are simply different theories to explain international trade. Trade is the concept of exchanging goods and services between two people or entities. International trade is then the concept of this exchange between people or entities in two different countries.

People or entities trade because they believe that they benefit from the exchange. They may need or want the goods or services. While at the surface, this may sound very simple, there is a great deal of theory, policy, and business strategy that constitutes international trade.

In this section, you’ll learn about the different trade theories that have evolved over the past century and which are most relevant today. Additionally, you’ll explore the factors that impact international trade and how businesses and governments use these factors to their respective benefits to promote their interests.

What Are the Different International Trade Theories?
People have engaged in trade for thousands of years. Ancient history provides us with rich examples such as the Silk Road—the land and water trade routes that covered more than four thousand miles and connected the Mediterranean with Asia.

“Around 5,200 years ago, Uruk, in southern Mesopotamia, was probably the first city the world had ever seen, housing more than 50,000 people within its six miles of wall. Uruk, its agriculture made prosperous by sophisticated irrigation canals, was home to the first class of middlemen, trade intermediaries...A cooperative trade network...set the pattern that would endure for the next 6,000 years.” [1]

In more recent centuries, economists have focused on trying to understand and explain these trade patterns. Chapter 1 "Introduction", Chapter 1, Section 4 "The Globalization Debate" discussed how Thomas Friedman’s flat-world approach segments history into three stages: Globalization 1.0 from 1492 to 1800, 2.0 from 1800 to 2000, and 3.0 from 2000 to the present. In Globalization 1.0, nations dominated global expansion. In Globalization 2.0, multinational companies ascended and pushed global development. Today, technology drives Globalization 3.0.

To better understand how modern global trade has evolved, it’s important to understand how countries traded with one another historically. Over time, economists have developed theories to explain the mechanisms of global trade. The main historical theories are called classical and are from the perspective of a country, or country-based. By the mid-twentieth century, the theories began to shift to explain trade from
a firm, rather than a country, perspective. These theories are referred to as modern and are firm-based or company-based. Both of these categories, classical and modern, consist of several international theories.

Classical or Country-Based Trade Theories

Mercantilism

Developed in the sixteenth century, mercantilism was one of the earliest efforts to develop an economic theory. This theory stated that a country’s wealth was determined by the amount of its gold and silver holdings. In its simplest sense, mercantilists believed that a country should increase its holdings of gold and silver by promoting exports and discouraging imports. In other words, if people in other countries buy more from you (exports) than they sell to you (imports), then they have to pay you the difference in gold and silver. The objective of each country was to have a trade surplus, or a situation where the value of exports are greater than the value of imports, and to avoid a trade deficit, or a situation where the value of imports is greater than the value of exports.
A closer look at world history from the 1500s to the late 1800s helps explain why mercantilism flourished. The 1500s marked the rise of new nation-states, whose rulers wanted to strengthen their nations by building larger armies and national institutions. By increasing exports and trade, these rulers were able to amass more gold and wealth for their countries. One way that many of these new nations promoted exports was to impose restrictions on imports. This strategy is called protectionism and is still used today.

Nations expanded their wealth by using their colonies around the world in an effort to control more trade and amass more riches. The British colonial empire was one of the more successful examples; it sought to increase its wealth by using raw materials from places ranging from what are now the Americas and India. France, the Netherlands, Portugal, and Spain were also successful in building large colonial empires that generated extensive wealth for their governing nations.

Although mercantilism is one of the oldest trade theories, it remains part of modern thinking. Countries such as Japan, China, Singapore, Taiwan, and even Germany still favor exports and discourage imports through a form of neo-mercantilism in which the countries promote a combination of protectionist policies and restrictions and domestic-industry subsidies. Nearly every country, at one point or another, has implemented some form of protectionist policy to guard key industries in its economy. While export-oriented companies usually support protectionist policies that favor their industries or firms, other companies and consumers are hurt by protectionism. Taxpayers pay for government subsidies of select exports in the form of higher taxes. Import restrictions lead to higher prices for consumers, who pay more for foreign-made goods or services. Free-trade advocates highlight how free trade benefits all members of the global community, while mercantilism’s protectionist policies only benefit select industries, at the expense of both consumers and other companies, within and outside of the industry.

Absolute Advantage

In 1776, Adam Smith questioned the leading mercantile theory of the time in *The Wealth of Nations.* Smith offered a new trade theory called absolute advantage, which focused on the ability of a country to produce a good more efficiently than another nation. Smith reasoned that trade between countries shouldn’t be regulated or restricted by government policy or intervention. He stated that trade should flow naturally according to market forces. In a hypothetical two-country world, if Country A could produce a good cheaper or faster (or both) than Country B, then Country A had the advantage and could focus on specializing on producing that good. Similarly, if Country B was better at producing another good, it could focus on specialization as well. By specialization, countries would generate efficiencies, because their labor force
would become more skilled by doing the same tasks. Production would also become more efficient, because there would be an incentive to create faster and better production methods to increase the specialization. Smith’s theory reasoned that with increased efficiencies, people in both countries would benefit and trade should be encouraged. His theory stated that a nation’s wealth shouldn’t be judged by how much gold and silver it had but rather by the living standards of its people.

**Comparative Advantage**

The challenge to the absolute advantage theory was that some countries may be better at producing both goods and, therefore, have an advantage in many areas. In contrast, another country may not have any useful absolute advantages. To answer this challenge, David Ricardo, an English economist, introduced the theory of comparative advantage in 1817. Ricardo reasoned that even if Country A had the absolute advantage in the production of both products, specialization and trade could still occur between two countries.

Comparative advantage occurs when a country cannot produce a product more efficiently than the other country; however, it can produce that product better and more efficiently than it does other goods. The difference between these two theories is subtle. Comparative advantage focuses on the relative productivity differences, whereas absolute advantage looks at the absolute productivity.

Let’s look at a simplified hypothetical example to illustrate the subtle difference between these principles. Miranda is a Wall Street lawyer who charges $500 per hour for her legal services. It turns out that Miranda can also type faster than the administrative assistants in her office, who are paid $40 per hour. Even though Miranda clearly has the absolute advantage in both skill sets, should she do both jobs? No. For every hour Miranda decides to type instead of do legal work, she would be giving up $460 in income. Her productivity and income will be highest if she specializes in the higher-paid legal services and hires the most qualified administrative assistant, who can type fast, although a little slower than Miranda. By having both Miranda and her assistant concentrate on their respective tasks, their overall productivity as a team is higher. This is comparative advantage. A person or a country will specialize in doing what they do relatively better. In reality, the world economy is more complex and consists of more than two countries and products. Barriers to trade may exist, and goods must be transported, stored, and distributed. However, this simplistic example demonstrates the basis of the comparative advantage theory.

**Heckscher-Ohlin Theory (Factor Proportions Theory)**

The theories of Smith and Ricardo didn’t help countries determine which products would give a country an advantage. Both theories assumed that free and open markets would lead countries and producers to
determine which goods they could produce more efficiently. In the early 1900s, two Swedish economists, Eli Heckscher and Bertil Ohlin, focused their attention on how a country could gain comparative advantage by producing products that utilized factors that were in abundance in the country. Their theory is based on a country’s production factors—land, labor, and capital, which provide the funds for investment in plants and equipment. They determined that the cost of any factor or resource was a function of supply and demand. Factors that were in great supply relative to demand would be cheaper; factors in great demand relative to supply would be more expensive. Their theory, also called the factor proportions theory, stated that countries would produce and export goods that required resources or factors that were in great supply and, therefore, cheaper production factors. In contrast, countries would import goods that required resources that were in short supply, but higher demand.

For example, China and India are home to cheap, large pools of labor. Hence these countries have become the optimal locations for labor-intensive industries like textiles and garments.

**Leontief Paradox**

In the early 1950s, Russian-born American economist Wassily W. Leontief studied the US economy closely and noted that the United States was abundant in capital and, therefore, should export more capital-intensive goods. However, his research using actual data showed the opposite: the United States was importing more capital-intensive goods. According to the factor proportions theory, the United States should have been importing labor-intensive goods, but instead it was actually exporting them. His analysis became known as the Leontief Paradox because it was the reverse of what was expected by the factor proportions theory. In subsequent years, economists have noted historically at that point in time, labor in the United States was both available in steady supply and more productive than in many other countries; hence it made sense to export labor-intensive goods. Over the decades, many economists have used theories and data to explain and minimize the impact of the paradox. However, what remains clear is that international trade is complex and is impacted by numerous and often-changing factors. Trade cannot be explained neatly by one single theory, and more importantly, our understanding of international trade theories continues to evolve.

**Modern or Firm-Based Trade Theories**

In contrast to classical, country-based trade theories, the category of modern, firm-based theories emerged after World War II and was developed in large part by business school professors, not economists. The firm-based theories evolved with the growth of the multinational company (MNC). The country-based theories couldn’t adequately address the expansion of either MNCs or intraindustry trade, which refers to
trade between two countries of goods produced in the same industry. For example, Japan exports Toyota vehicles to Germany and imports Mercedes-Benz automobiles from Germany. Unlike the country-based theories, firm-based theories incorporate other product and service factors, including brand and customer loyalty, technology, and quality, into the understanding of trade flows.

**Country Similarity Theory**

Swedish economist Steffan Linder developed the country similarity theory in 1961, as he tried to explain the concept of intraindustry trade. Linder’s theory proposed that consumers in countries that are in the same or similar stage of development would have similar preferences. In this firm-based theory, Linder suggested that companies first produce for domestic consumption. When they explore exporting, the companies often find that markets that look similar to their domestic one, in terms of customer preferences, offer the most potential for success. Linder’s country similarity theory then states that most trade in manufactured goods will be between countries with similar per capita incomes, and intraindustry trade will be common. This theory is often most useful in understanding trade in goods where brand names and product reputations are important factors in the buyers’ decision-making and purchasing processes.

**Product Life Cycle Theory**

Raymond Vernon, a Harvard Business School professor, developed the product life cycle theory in the 1960s. The theory, originating in the field of marketing, stated that a product life cycle has three distinct stages: (1) new product, (2) maturing product, and (3) standardized product. The theory assumed that production of the new product will occur completely in the home country of its innovation. In the 1960s this was a useful theory to explain the manufacturing success of the United States. US manufacturing was the globally dominant producer in many industries after World War II.

It has also been used to describe how the personal computer (PC) went through its product cycle. The PC was a new product in the 1970s and developed into a mature product during the 1980s and 1990s. Today, the PC is in the standardized product stage, and the majority of manufacturing and production process is done in low-cost countries in Asia and Mexico.

The product life cycle theory has been less able to explain current trade patterns where innovation and manufacturing occur around the world. For example, global companies even conduct research and development in developing markets where highly skilled labor and facilities are usually cheaper. Even though research and development is typically associated with the first or new product stage and therefore completed in the home country, these developing or emerging-market countries, such as India and China, offer both highly skilled labor and new research facilities at a substantial cost advantage for global firms.
Global Strategic Rivalry Theory

Global strategic rivalry theory emerged in the 1980s and was based on the work of economists Paul Krugman and Kelvin Lancaster. Their theory focused on MNCs and their efforts to gain a competitive advantage against other global firms in their industry. Firms will encounter global competition in their industries and in order to prosper, they must develop competitive advantages. The critical ways that firms can obtain a sustainable competitive advantage are called the barriers to entry for that industry. The barriers to entry refer to the obstacles a new firm may face when trying to enter into an industry or new market. The barriers to entry that corporations may seek to optimize include:
- research and development,
- the ownership of intellectual property rights,
- economies of scale,
- unique business processes or methods as well as extensive experience in the industry, and
- the control of resources or favorable access to raw materials.

Porter’s National Competitive Advantage Theory

In the continuing evolution of international trade theories, Michael Porter of Harvard Business School developed a new model to explain national competitive advantage in 1990. Porter’s theory stated that a nation’s competitiveness in an industry depends on the capacity of the industry to innovate and upgrade. His theory focused on explaining why some nations are more competitive in certain industries. To explain his theory, Porter identified four determinants that he linked together. The four determinants are (1) local market resources and capabilities, (2) local market demand conditions, (3) local suppliers and complementary industries, and (4) local firm characteristics.
Local Firm Characteristics
Local Market Resources and Capabilities
Local Suppliers and Complementary Industries
1. **Local market resources and capabilities (factor conditions).** Porter recognized the value of the factor proportions theory, which considers a nation’s resources (e.g., natural resources and available labor) as key factors in determining what products a country will import or export. Porter added to these basic factors a new list of advanced factors, which he defined as skilled labor, investments in education, technology, and infrastructure. He perceived these advanced factors as providing a country with a sustainable competitive advantage.

2. **Local market demand conditions.** Porter believed that a sophisticated home market is critical to ensuring ongoing innovation, thereby creating a sustainable competitive advantage. Companies whose domestic markets are sophisticated, trendsetting, and demanding forces continuous innovation and the development of new products and technologies. Many sources credit the demanding US consumer with forcing US software companies to continuously innovate, thus creating a sustainable competitive advantage in software products and services.

3. **Local suppliers and complementary industries.** To remain competitive, large global firms benefit from having strong, efficient supporting and related industries to provide the inputs required by the industry. Certain industries cluster geographically, which provides efficiencies and productivity.

4. **Local firm characteristics.** Local firm characteristics include firm strategy, industry structure, and industry rivalry. Local strategy affects a firm’s competitiveness. A healthy level of rivalry between local firms will spur innovation and competitivenes.

In addition to the four determinants of the diamond, Porter also noted that government and chance play a part in the national competitiveness of industries. Governments can, by their actions and policies, increase the competitiveness of firms and occasionally entire industries.

Porter’s theory, along with the other modern, firm-based theories, offers an interesting interpretation of international trade trends. Nevertheless, they remain relatively new and minimally tested theories.

### Which Trade Theory Is Dominant Today?

The theories covered in this chapter are simply that—theories. While they have helped economists, governments, and businesses better understand international trade and how to promote, regulate, and manage it, these theories are occasionally contradicted by real-world events. Countries don’t have absolute advantages in many areas of production or services and, in fact, the factors of production aren’t neatly distributed between countries. Some countries have a disproportionate benefit of some factors. The United States has ample arable land that can be used for a wide range of agricultural products. It also has extensive access to capital. While it’s labor pool may not be the cheapest, it is among the best educated in the world.

These advantages in the factors of production have helped the United States become the largest and richest economy in the world. Nevertheless, the United States also imports a vast amount of goods and services, as US consumers use their wealth to purchase what they need and want—much of which is now manufactured in other countries that have sought to create their own comparative advantages through cheap labor, land, or production costs.
As a result, it's not clear that any one theory is dominant around the world. This section has sought to highlight the basics of international trade theory to enable you to understand the realities that face global businesses. In practice, governments and companies use a combination of these theories to both interpret trends and develop strategy. Just as these theories have evolved over the past five hundred years, they will continue to change and adapt as new factors impact international trade.

**Important Note:** It may kindly be noted that the documents listed below at Sl.No.s 1 to 5 must be sent/deposited to Registrar/Principal of the Coordinating Institute as to reach on or before 25.11.2014.

1. Print the application form from the Complete Form, affix the identical passport size photographs in the space provided, put your signatures at the required places and send it to Registrar/Principal of College of Vocational Studies, Triveni (Sheikh Sarai), Phase-II, New Delhi-110017.
2. Copy of the Bank eChallan (Coordinating Institute copy), if applicable.
3. Attendance Slip duly signed with photograph (One copy).
4. Attested copies of SC/ST/Persons with Disability (PWD)/OBC (Non creamy layer) certificates, in case applicable.
5. Certificate of educational qualification/research experience, in case applicable, entitling the candidate for age relaxation, duly attested by a Gazetted Officer.