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# Trade Theory in International Economics

Krzysztof Król

Faculty of Economics

Maria Curie-Skłodowska University

Email: krolkrzysztof875@gmail.com (Author of Correspondence)

Poland

## Abstract

You will get an overview about the nature of trade theory. Many terms related international trade here will be discussed. Overview of Mercantilism we will discuss here. Theory of absolute advantage will be deeply discussed here. Comparative Advantage related the advantage term here I will describe. In this article the ideas of Heckscher-Olin Theory, new Trade Theory and the theory of Porter's Diamond will be discussed. By this article, we will be able to clearly understand international trade. WE will be able to compare and contrast different trade theories.

**Keywords:** Separate; Free trade; Classical; Mercantilism; One-Factor.

## 1. Introduction

Trade Theories refer to international trade by learning which we will get ability to explain international trade. 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 many sound very simple, there is a great deal of theory, policy, and business strategy that constitutes international trade. International trade theories are simply different theories. 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.

## 2. International Economics is a Separate Field

International trade theory and domestic microeconomics both rest on the same assumption that economic agents maximize their own self-interest. Nevertheless, there are important differences between domestic and foreign transactions. Similarly, international finance is closely tied to domestic macroeconomics, but political borders do matter, and international finance is far more than a modest extension of domestic macroeconomics.

Within a national economy labor and capital generally are free to move among regions. There are normally no government-imposed barriers to the shipment of goods within a country. Accordingly, firms in one region compete against firms in another region of the country without government protection in the form of tariffs or quotas. Domestic microeconomics deals with such free trade within a country. In contrast, tariffs, quotas and other government-imposed barriers to trade are almost universal in international trade. A large part of international trade theory deals with why such barriers are imposed, how they operate, and what effects they have on flows of trade and other aspects of economic performance. Domestic macroeconomics normally deals with monetary and fiscal policy choices that address cyclical economic fluctuations that affect the country as a whole. A country normally has a single currency, the supply of which is managed by the central bank operating through a commercial banking system. Because a New York dollar is the same as a California dollar, for example, there are no internal exchange markets or exchange rates in the United States.

## 3. Idea of International Trade

Trade theory shows why it is beneficial for a country to engage in international trade even for products it is able to produce for itself. WE may get the idea by the exchange of raw materials and manufactured goods across national borders. BY the idea we will learn implications for international business. The Benefits of Trade allow a country to specialize in the manufacture and export of products that can be produced most efficiently in that country. The Pattern of International Trade displays patterns that are are easy to understand. Others are not so easy to understand. This explains why it is beneficial for countries to engage in international trade. This helps countries formulate their economic policy. Trade explains the pattern of international trade in the world economy. International trade allows a country to specialize in the manufacture and export of products and services that it can produce efficiently import products and services that can be produced more efficiently in other countries limits on imports may be beneficial to producers, but not beneficial for consumers.

## 4. Idea of Free Trade

Free trade is basically a situation where a government does not attempt to influence through quotas or duties what its citizens can buy from another country or what they can produce and sell to another country. Free trade refers to a situation where a government does not attempt to influence through quotas or duties what its citizens can buy from another country or what they can produce and sell to another country. Free Trade occurs when a government does not attempt to influence, through quotas or duties, what its citizens can buy from another country or what they can produce and sell to another country.

## 5. Two Types of Trade Theories

### *5.1. Classical Trade Theories*

One of the examples is Mercantilism that takes an us-versus-them view of trade and discusses about other country's gain is our country's loss. Again free trade theories are part of this. Absolute Advantage, Comparative Advantage, Specialization of production and free flow of goods benefit all trading partners' economies are here discussed. Free Trade refined factor-proportions, International product life cycle.

### *5.2. The New Trade Theory*

As output expands with specialization, an industry's ability to realize economies of scale increases and unit costs decrease. Because of scale economies, world demand supports only a few firms in such industries .Countries that had an early entrant to such an industry have an advantage:

a) Fist-mover advantage

b) Barrier to entry

Global Strategic Rivalry refers to Firms gain competitive advantage trough: intellectual property, R&D, economies of scale and scope, experience. National Competitive Advantage introduced by Porter,  in 1990.

## 6. International Trade Theory Evolved

Mercantilism (16$^{th}$ and 17$^{th}$ centuries) promoted the idea of encouraging exports and discouraging imports in 1776, Adam Smith promoted the idea of unrestricted free trade. In the 19$^{th}$ century, David Ricardo built on Smith ideas, and in the 20$^{th}$ century, Eli Heckscher and Bertil Ohlin refined Ricardo's work.

## 7. It is Beneficial for Countries to Engage in Free Trade

The theories of Smith, Ricardo and Heckscher-Ohlin show why it is beneficial for a country to engage in international trade even for products it is able to produce for itself

International trade allows a country to specialize in the manufacture and export of products that can be produced most efficiently in that country, and import products that can be produced more efficiently in other countries

**8. Mercantilism**

It was prevailed in 1500 – 1800 BC. It refers-

a) Export more to "strangers" than we import to amass treasure, expand kingdom

b) Zero-sum vs positive-sum game view of trade

Government intervenes to achieve a surplus in exports

King, exporters, domestic producers becomes happy in this.

A nation's wealth depends on accumulated treasure. Gold and silver are the currency of trade.

This theory says you should have a trade surplus. It establishes maximize exports through subsidies. It minimizes imports through tariffs and quotas.

Mercantilism is problematic and not economically valid, yet many political views today have the goal of boosting exports while limiting imports by seeking only selective liberalization of trade. Mercantilism developed in mid-16$^{th}$ century suggests that it is in a country's best interest to maintain a trade surplus -to export more than it imports. This advocates government intervention to achieve a surplus in the balance of trade. Mercantilism views trade as a zero-sum game one in which a gain by one country results in a loss by another. Mercantilism weakens country in long run; enriches only a few.

**9. Absolute Advantage**

Adam Smith established this idea in 1776 in his book The Wealth of Nations. He argued that a country has an absolute advantage in the production of a product when it is more efficient than any other country in producing it. We can characterized the ideas of absolute advantage by –

a) Capability of one country to produce more of a product with the same amount of input than another country.

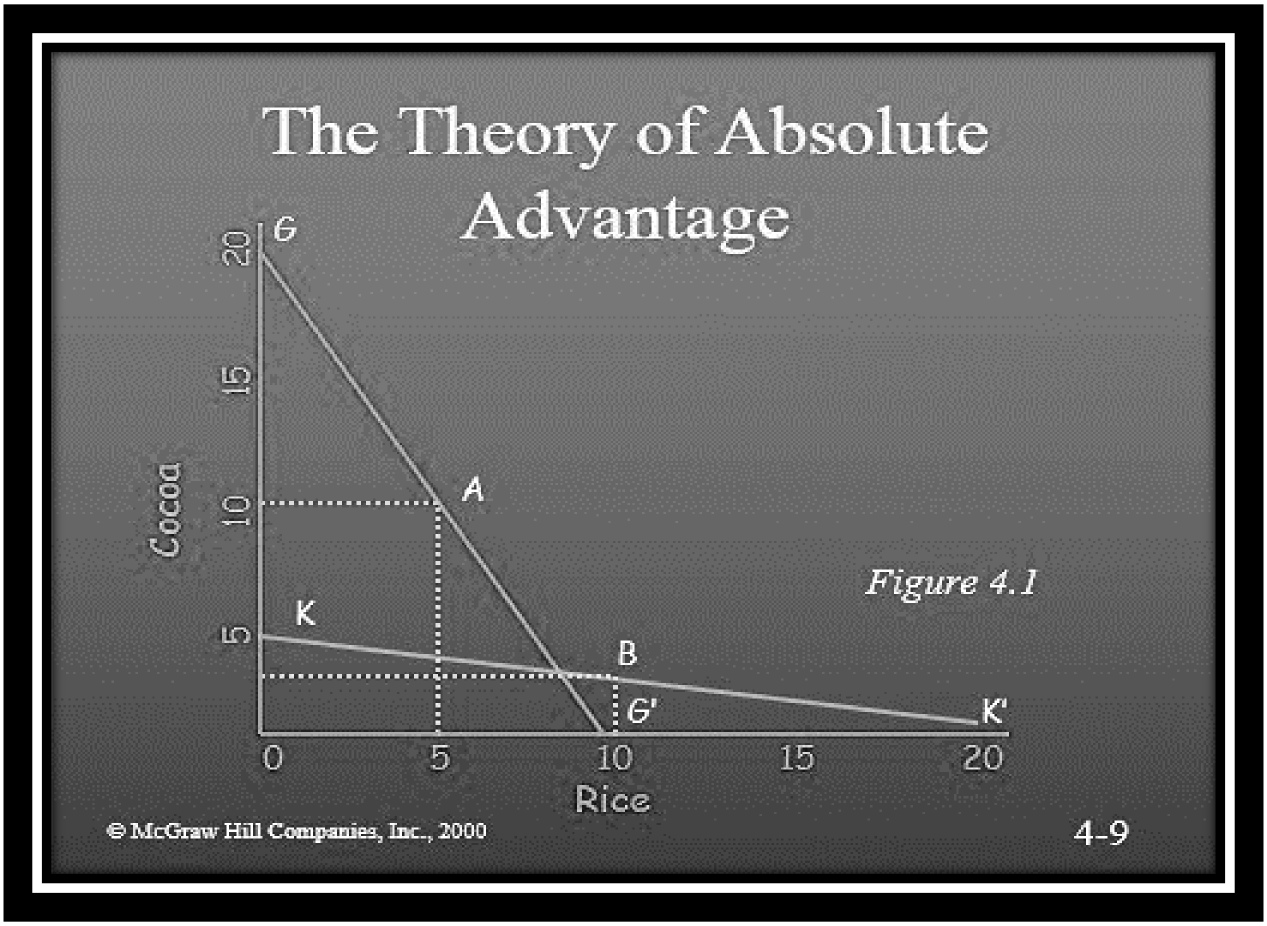
b) Produce only goods where you are most efficient, trade for those where you are not efficient.

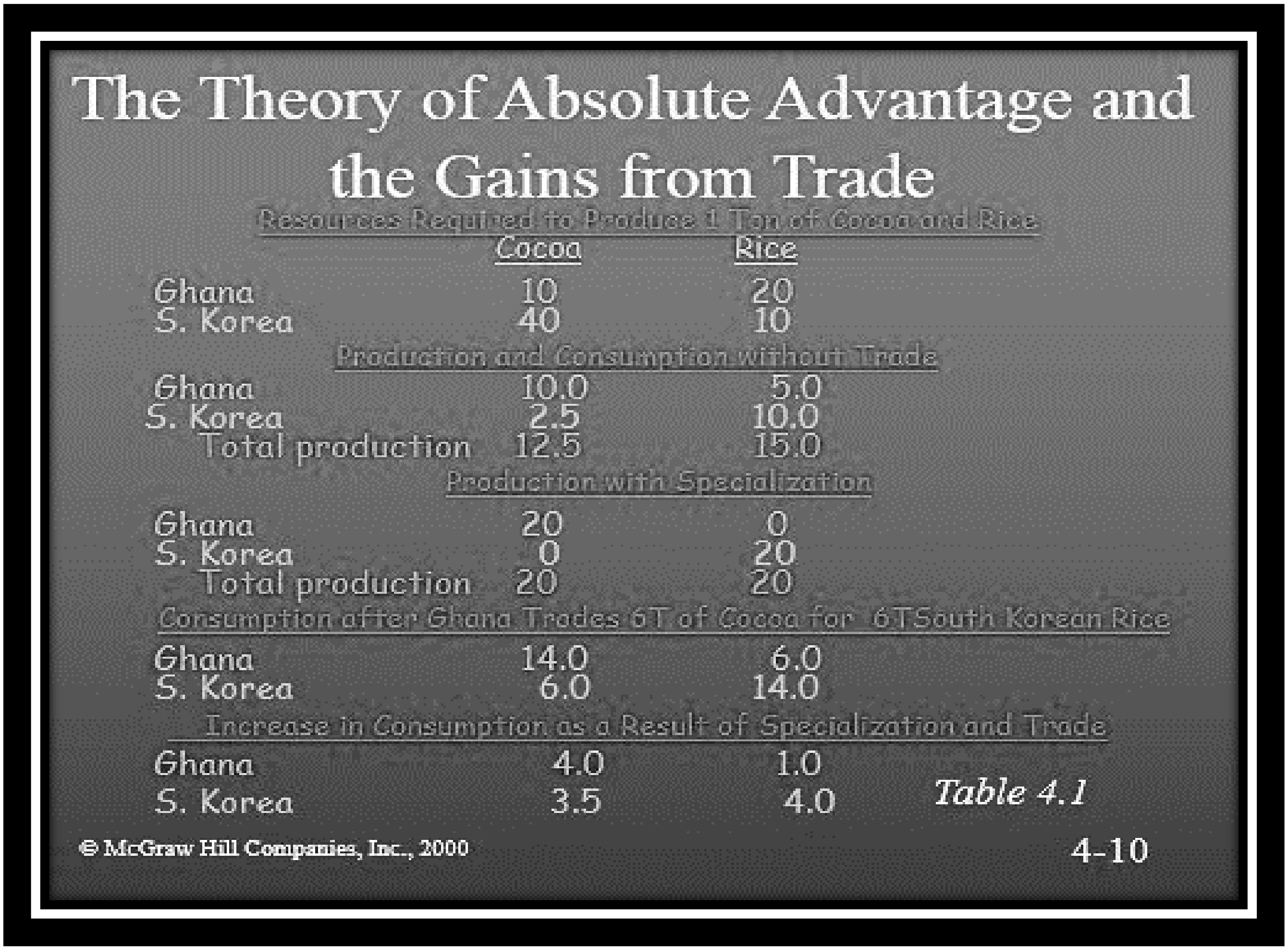
c) Assumes there is an absolute advantage balance among nations.

d) A country

e) Has absolute advantage when it is more productive than another country in producing a particular product.

f) Should specialize in production of and export products for which it has absolute advantage; import other products.





The Theory of Absolute Advantage and the Gains from Trade

| Resources Required to Produce 1 Ton of Cocoa and Rice | Cocoa | Rice |
|---|---|---|
| Ghana | 10 | 20 |
| S. Korea | 40 | 10 |
| **Production and Consumption without Trade** | | |
| Ghana | 10.0 | 5.0 |
| S. Korea | 2.5 | 10.0 |
| Total production | 12.5 | 15.0 |
| **Production with Specialization** | | |
| Ghana | 20 | 0 |
| S. Korea | 0 | 20 |
| Total production | 20 | 20 |
| **Consumption after Ghana Trades 6T of Cocoa for 6TSouth Korean Rice** | | |
| Ghana | 14.0 | 6.0 |
| S. Korea | 6.0 | 14.0 |
| **Increase in Consumption as a Result of Specialization and Trade** | | |
| Ghana | 4.0 | 1.0 |
| S. Korea | 3.5 | 4.0 |

Table 4.1



4-10

**10. Comparative Advantage**

A country has a comparative advantage in producing a good if the opportunity cost of producing that good in terms of other goods is lower in that country than it is in other countries. In this example, South America has a comparative advantage in winter roses and the United States has a comparative advantage in computers. The standard of living can be increased in both places if South America produces roses for the U.S. market, while the United States produces computers for the South American market. We therefore have an essential insight about comparative advantage and international trade: Trade between two countries can benefit both countries if each country exports the goods in which it has a comparative advantage. This idea was presented by David Ricardo in his book *Principles of Political Economy* in 1817. Absolute Advantage is a special case of Comparative Advantage.

We can explain this by saying -

a) Country should specialize in the production of those goods in which it is relatively more productive... even if it has absolute advantage in all goods it produces

b) Extends free trade argument

c) Efficiency of resource utilization leads to more productivity.

d) Should import even if country is more efficient in the product’s production than country from which it is buying.

e) Look to see how much more efficient. If only comparatively efficient, than import.

f) Makes better use of resources

g) Trade is a positive-sum game.

**11. One-Factor Economy**

To introduce the role of comparative advantage in determining the pattern of international trade, we begin by imagining that we are dealing with an economy—which we call Home-—that has only one factor of production. (In later chapters we extend the analysis to models in which there are several factors.) We imagine that only two goods, wine and cheese, are produced. The technology of Home's economy can be summarized by labor productivity in each industry, expressed in terms of the unit labor requirement, the number of hours of labor required to produce a pound of cheese or a gallon of wine. For example, it might require 1 hour of labor to produce a pound of cheese, 2 hours to produce a gallon of wine. For future reference, we define aLW and aLC as the unit labor requirements in wine and cheese production, respectively. The economy's total resources are defined as L, the total labor supply.

**12. Misconceptions about Comparative Advantage**

There is no shortage of muddled ideas in economics. Politicians, business leaders, and even economists frequently make statements that do not stand up to careful economic analysis. For some reason this seems to be especially true in international economics. Open the business section of any Sunday newspaper or weekly news magazine and you will probably find at least one article that makes foolish statements about international trade. Three misconceptions in particular have proved highly persistent, and our simple model of comparative advantage can be used to see why they are incorrect.

***12.1. The Pauper Labor Argument***

This argument, sometimes referred to as the pauper labor argument, is a particular favorite of labor unions seeking protection from foreign competition. People who adhere to this belief argue that industries should not have to cope with foreign industries that are less efficient but pay lower wages. This view is widespread and has acquired considerable political influence. In 1993 Ross Perot, a self-made billionaire and former presidential candidate, warned that free trade between the United States and Mexico, with its much lower wages, would lead to a "giant sucking sound" as U.S. industry moved south. In the same year Sir James Goldsmith, another self-made billionaire who was an influential member of the European Parliament, offered similar if less picturesquely expressed views in his book The Trap, which became a best-seller in France. Again, our simple example reveals the fallacy of this argument. In the example, Home is more productive than Foreign in both industries, and Foreign's lower cost of wine production is entirely due to its much lower wage rate. Foreign's lower wage rate is, however, irrelevant to the question of whether Home gains from trade. Whether the lower cost of wine produced in Foreign is due to high productivity or low wages does not matter. All that matters to Home is that it is cheaper in terms of its own labor for Home to produce cheese and trade it for wine than to produce wine for itself. This is fine for Home, but what about Foreign? Isn't there something wrong with basing one's exports on low wages? Certainly it is not an attractive position to be in, but the idea that trade is good only if you receive high wages is our final fallacy.

## 13. Porter’s Diamond

this was published in Harvard Business School in 1990. This is considered as *The Competitive Advantage of Nations.* This has been looked at 100 industries in 10 nations. Thought existing theories didn’t go far enough. Michael Porter (1990) tried to explain why a nation achieves international success in a particular industry. Porter identified four attributes that promote or impede the creation of competitive advantage. Here the Factor endowments is an important term. This theory focuses on

a) Demand conditions
b) Relating and supporting industries
c) Firm strategy, structure, and rivalry

### *13.1. Determinants of National Competitive Advantage*

Now I am describing these. Factor endowments: nation’s position in factors of production such as skilled labor or infrastructure necessary to compete in a given industry. Firm strategy, structure and rivalry: the conditions in the nation governing how companies are created, organized, and managed and the nature of domestic rivalry. Demand conditions: the nature of home demand for the industry’s product or service. Related and supporting industries: the presence or absence in a nation of supplier industries or related industries that are nationally competitive.

### *13.2. The Diamond*

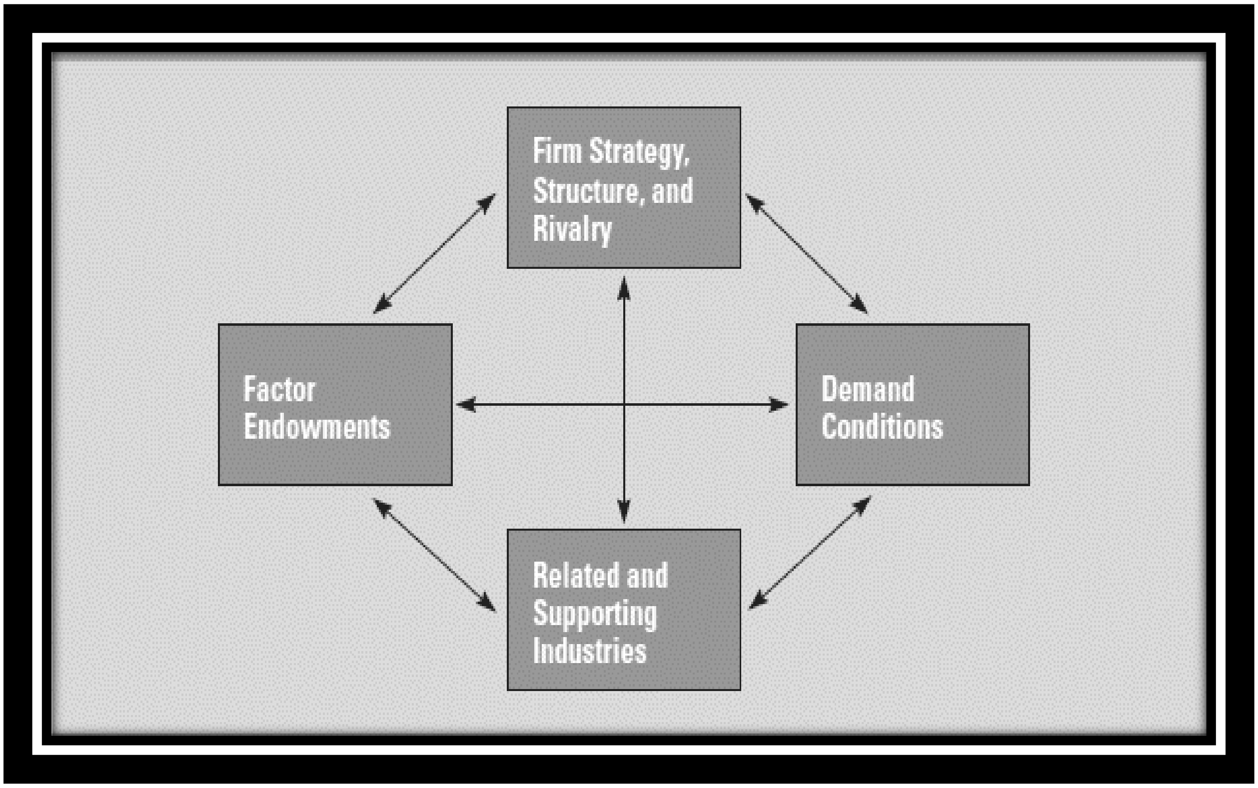
The natures of this diamond are-

a) Success occurs where these attributes exist.

b) More/greater the attribute, the higher chance of success.

c) The diamond is mutually reinforcing.

Porter's Diamond of Competitive Advantage




### *13.3. Porter's Theory Holds*

a) Government policy can affect demand through product standards and influence rivalry through regulation and antitrust laws

b) This theory impacts the availability of highly educated workers and advanced transportation infrastructure.

c) The four attributes, government policy, and chance work as a reinforcing system, complementing each other and in combination creating the conditions appropriate for competitive advantage

d) So far, Porter's theory has not been sufficiently tested to know how well it holds up

## 14. Heckscher-Ohlin Theory

The Heckscher–Ohlin theorem is one of the four critical theorems of the Heckscher–Ohlin model, developed by Swedish economist Eli Heckscher and Bertil Ohlin (his student). In the two-factor case, it states: "A capital-abundant country will export the capital-intensive good, while the labor-abundant country will export the labor-intensive good."Eli Heckscher (1919) and Bertil Ohlin (1933) - comparative advantage arises from differences in national factor endowments .This is the more abundant a factor, the lower its cost. Heckscher and Ohlin predict that countries will export goods that make intensive use of locally abundant factors and import goods that make intensive use of factors that are locally scarce.

Heckscher-Ohlin theory holds Wassily Leontief (1953) theorized that since the U.S. was relatively abundant in capital compared to other nations, the U.S. would be an exporter of capital intensive goods and an importer of labor-intensive goods. However, he found that U.S. exports were less capital intensive than U.S. imports.

Since this result was at variance with the predictions of trade theory, it became known as the Leontief Paradox.

**15. Product Life Cycle Theory**

The product life-cycle theory - as products mature both the location of sales and the optimal production location will change affecting the flow and direction of trade. It was proposed by Ray Vernon in the mid-1960s. Globalization and integration of the world economy has made this theory less valid today the theory is ethnocentric and production today is dispersed globally and products today are introduced in multiple markets simultaneously.

**16. Conclusion**

International trade theory is a sub-field of economics. Thus this analyzes the patterns of international trade. Thus this discusses its origins, and its welfare implications. This has been highly controversial since the 18th century up to our days. International trade theory and economics itself have developed as means to evaluate the effects of trade policies.

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