Chapter 5

Theories of International Trade and Investment

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Mercantilism and Neomercantilism

- **Mercantilism**: A belief popular in the 16th century that national prosperity results from maximizing exports and minimizing imports.
- Today, some argue for *neomercantilism* – the idea that the nation should run a trade surplus.
- Supporters of neomercantilism include:
  - Labor unions (who want to protect domestic jobs),
  - Farmers (who want to keep crop prices high), and
  - Some manufacturers (that rely on exports).

Free Trade

The absence of restrictions to the
flow of goods and services among nations.

- Free trade is usually best because it leads to:
  - More and better choices for consumers and firms.
  - Lower prices of goods for consumers and firms.
  - Higher profits and better worker wages (because imported input goods are usually cheaper).
  - Higher living standards for consumers (because their costs are lower).
  - Greater prosperity in poor countries.

Comparative Advantage

- The foundation concept of international trade, which answers the question of how nations can achieve and sustain economic success and prosperity.
- It refers to the superior features of a country that provide it with unique benefits in global competition.
- Comparative advantages are derived either from natural endowments or from deliberate national policies.

Examples of National Comparative Advantage

- France has a climate and soil superior for producing wine.
- Saudi Arabia has a natural abundance of oil, for the production of petroleum products.
- Over time, Japan has acquired a superior base of knowledge and experience for producing cars.
- Over time, India has acquired a superior base of IT workers for producing computer software.

What are the comparative advantages in your country?

Competitive Advantage

- A foundation concept that explains how individual firms gain and maintain distinctive competencies, relative to competitors, that lead to superior performance.
- It refers to the distinctive assets, competencies, and capabilities that are developed or acquired by the firm.
- The collective competitive advantages held by the firms in a nation are the basis for the competitive advantages of the nation at large.

Factor Proportions Theory

- Also known as Factor Endowments Theory. It argues that each country should produce and export products that intensively use relatively abundant factors of production, and import goods that intensively use relatively scarce factors of production.

International Product Life Cycle Theory

- Each product and its associated manufacturing technologies go through three stages of evolution: Introduction, maturity, and standardization.

- In the *introduction* stage, the inventor country enjoys a monopoly both in manufacturing and exports. Example: The television set.

New Trade Theory

- Argues that *economies of scale* are an important factor in some industries for superior international performance, even in the absence superior comparative advantages. Some industries succeed best as their volume of production increases.

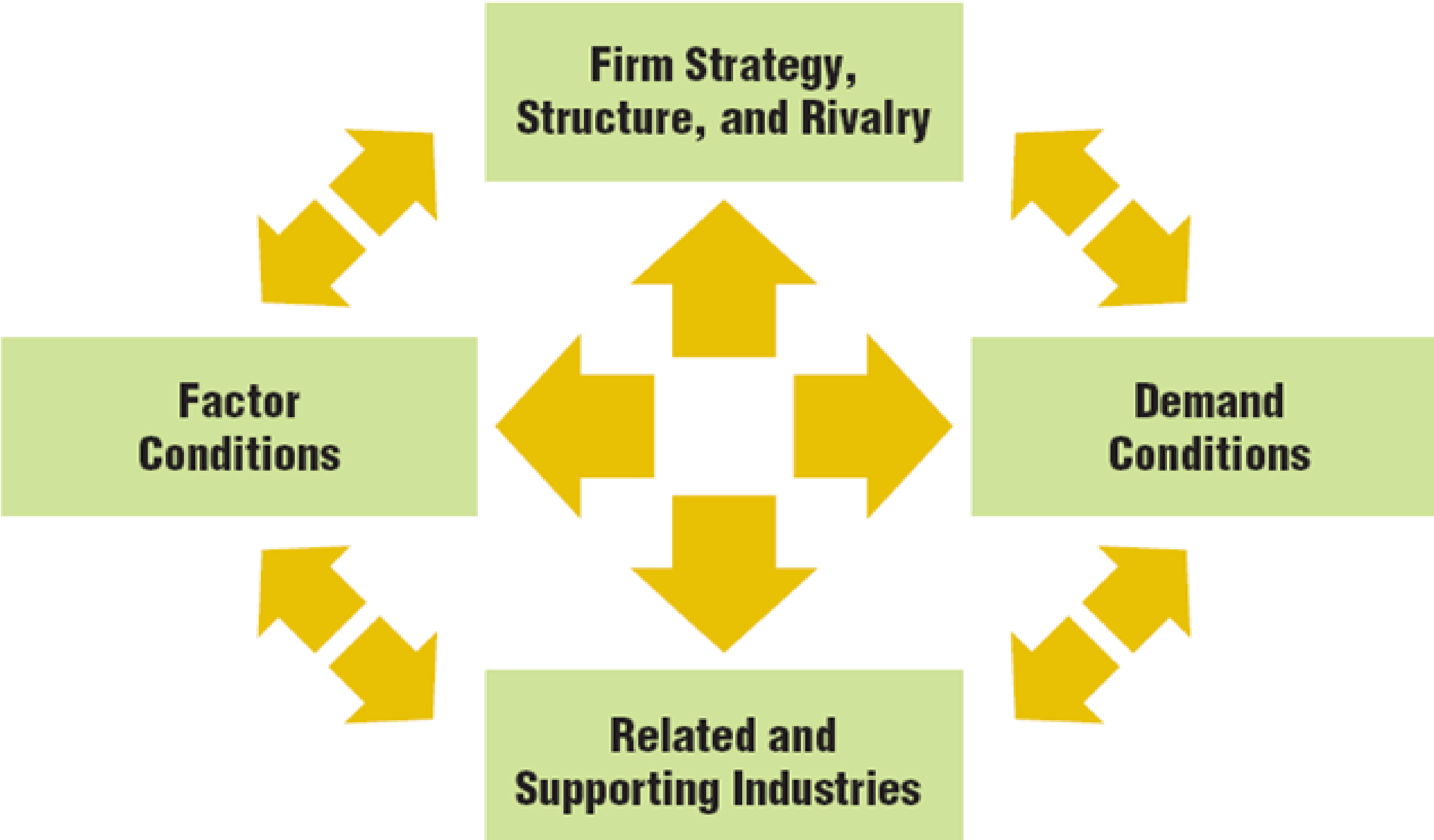
<u>Example</u>

The commercial aircraft industry has very high fixed costs that necessitate high-volume sales to achieve profitability.

Critical Role of Innovation in National Economic Success

- Innovation is a *key* source of competitive advantage.
- The firm innovates in four major ways. It can develop:
  (1) A new product or improve an existing product.
  (2) New ways of manufacturing.
  (3) New ways of marketing.
  (4) New ways of organizing company operations.
- Many innovative firms in a nation leads to national competitive advantage

Michael Porter's Diamond Model: Sources of National Competitive Advantage



Diamond Model

Sources of National Competitive Advantage (cont'd)

- **Factor conditions** – Quality and quantity of labor, natural resources, capital, technology, know-how, entrepreneurship, and other factors of production.

<u>Example</u>

An abundance of cost-effective and well-educated workers give China a competitive advantage in the production of laptop computers.

Diamond Model

Sources of National Competitive Advantage (cont'd)

- **Related and supporting industries** – the presence of suppliers, competitors, and complementary firms that excel within a given industry.

<u>Example</u>

The Silicon Valley in California is a great place to launch a computer software firm, because it is home to thousands of knowledgeable firms and workers in the software industry.

Diamond Model

Sources of National Competitive Advantage (cont’d)

- **Demand conditions at home** – the strengths and sophistication of customer demand.

Example

Japan is a densely populated, hot, and humid country with very demanding consumers. These conditions led Japan to become one of the leading producers of superior, compact air conditioners

Diamond Model

Sources of National Competitive Advantage (cont'd)

- Firm strategy, structure, and rivalry – The nature of domestic rivalry, and conditions that determine how a nation's firms are created, organized, and managed.

<u>Example</u>

Italy has many top firms in design industries such as textiles, furniture, lighting, and fashion. Vigorous competitive rivalry puts these firms under constant pressure to innovate, which has propelled Italy to a leading position in design, worldwide.

Industrial Cluster

- A concentration of suppliers and supporting firms from the same industry located within the same geographic area. Similar to Porter's *Related and Supporting Industries*.

- A strong cluster can serve as an export platform for the nation.

<u>Examples</u>

Silicon Valley; pharmaceutical cluster in Switzerland; footwear industry in Pusan, South Korea; IT industry in Bangalore, India; fashion cluster in northern Italy; and Silicon Valley North near Ottawa, Canada.

National Industrial Policy

- A proactive economic development plan employed by the government to nurture or support promising industry sectors with potential for regional or global dominance. Initiatives can include:
  - Tax incentives.
  - Monetary and fiscal policies.
  - Rigorous educational system.
  - Investment in national infrastructure.
  - Strong legal and regulatory systems.

FDI Based Explanations:

Monopolistic Advantage Theory

- Argues that MNEs prefer FDI because it provides the firm with control over resources and capabilities in the foreign market, and a degree of monopoly power relative to foreign competitors.

- Key sources of monopolistic advantage include proprietary knowledge, patents, unique know-how, and sole ownership of other assets

<u>Example</u>

Novartis earns substantial profits by marketing various patent medications through its subsidiaries worldwide.

FDI Based Explanations:

Dunning's Eclectic Paradigm

- Three conditions determine whether or not a company will enter a given foreign country via FDI:

1. *Ownership-specific advantages* – knowledge, skills, capabilities, relationships, or physical assets that the firm owns and which are the basis of its competitive advantages.
2. *Location-specific advantages* – similar to comparative advantages, they are specific advantages that exist in the country that the MNE has entered, or is seeking to enter, such as natural resources, low-cost labor, or skilled labor.
3. *Internalization advantages* – control derived from internalizing foreign-based manufacturing, distribution, or other value chain activities.

Example of the Eclectic Paradigm: Sony in China

- ***Ownership specific advantages:*** Sony possesses a huge stock of knowledge and patents in the consumer electronics industry, as represented by products like the Playstation and Vaio laptop.
- ***Location specific advantages:*** Sony desires to manufacture in China, to take advantage of China's low-cost, highly knowledgeable labor.
- ***Internalization advantages***: Sony wants to maintain control over its knowledge, patents, manufacturing processes, and quality of its products.

Thus, Sony entered China via FDI