BMGC Homework 2

1. What are the strengths and weaknesses of the classical theories of international trade?

Classical theories of international trade were a forerunners of new, more complex and modernised theories.

Consider **mercantilism theory** theory's main advantage is that it f*ocuses on increase of exports and protection of domestic market*. While this theory *was effective in 16th and 17th centuries for France, Great Britain and Prussia making them powerful world economies*, it has outlived itself because of *limitations in development and innovations* and economic imbalance caused by minimal import and running out local resources.

An obvious strength of **theory of absolute advantage** is the proof how *trade can be not a zero-sum but a win-win game*, thus destroying mercantilism. For example, Italy can produce leather jackets with a lower cost and better quality than USA, while US can produce PCs cheaper and faster than Italy - so each country should specialise on sphere it is better in, so they could both trade and benefit. Nevertheless, this theory exclude the case when *one nation is absolutely inferior to another* and the fact that with many nations the *difficulty to find an absolute advantage increases*.

Comparative advantage theory took into account disadvantages of Adam Smith's theory and showed that trade is beneficial even if one of the countries does not have an absolute advantage in production of any particular good. Suppose India and USA produce both clothes and cheese and US have absolute advantage in production of both. As long as India *is not equally less efficient* in the production of both goods, India can still *choose to specialise in the production* of one good for which it has comparative advantage. However, this theory is *static* and assumes that *comparative advantage does not change over time*.

Factor endowment theory *explains patterns of trade based on factor endowments*, but does not take into account two things: 1) as nations specialise in the production of goods for which they have abundant resources, those holding the scarce resources are less in demand and 2) factor endowments evolve over time. For example, during 1990s China was a major provider of light manufacturing, because of the advantage in unskilled labor, but now has stronger endowments of capital and skilled labor, so country's economy has shifted towards more advanced manufacturing.

In conclusion, we can say that despite having a lot of disadvantages, these theories still shaped modern trade theories.

2. How can the product life cycle explain the patterns of international trade? According to Michael Porter, what factors contribute to a country's competitiveness?

Product life cycle theory and M. Porter's factors of firms competitiveness are somewhat complementary: one suggests how products enter international market, while other explains how firms can stay competitive on it.

Product life cycle theory is based on a few assumptions:1) new products are likely to be introduced in United States; 2) first foreign countries which start to produce them are Western European countries. The theory explains patterns of international trade by suggesting that the new product is developed and produced in USA to some point until Western European countries start its production and export to other countries (third market particularly), after which the product is spread so much that foreign firms start to compete with American firms on US market.

M. Porter underlined **four factors that determine competitiveness of firm** on international area: factor conditions, demand conditions, related and supporting industries and firm strategy, structure and rivalry.

Both factor conditions and demand conditions are based on people: M. Porter highlighted the fact that human resources are more valuable than natural resources: "nations succeed in industries where they are particularly good at **factor creation**"(1) where creation of factors is depended on people. While sophisticated **demand is a motivation for firms** to improve their product.

The presence of **related and supporting industries provides the foundation on which the local industry can excel**. For the last factor M. Porter underlined that the **national context** in which companies operate largely **determines how companies are created, organised and managed**. For example, in industries where Italian companies are world leaders a company's strategy emphasises those characteristics that fit both the dynamics of the industry and the character of the Italian management system. Rivalry too plays a huge role: **domestic rivalry motivates firms to innovate and improve** in order to stay competitive and enter international area. A good example for this is the Japanese automobile industry with intense rivalry between players (Nissan, Honda, Toyota etc.) helped them compete in foreign markets too.

In conclusion Michael Porter underlines four factors that determine competitiveness of firm, while product life cycle theory explains how firms enter international area.

1- this quote was taken from the original M. Porter's review

3. Using examples illustrate how economic and political institutions influence international trade (WTO, IMF, OPEC, regional economic blocks).

Various events in human history have led to the creation of political and economic institutions that can influence trade processes between countries in order to help integrate trade and structure and unify trade processes, resolve disputes and maintain the economic balance of countries.

One of such institutions is the WTO, whose main goal is to liberalise international trade and regulate trade and political relations of member countries. One of the cases when the **WTO influenced trade policies between countries is the "shrimp-turtle" case**. Asian countries that used a certain method of catching shrimp that was considered dangerous (as a result it was banned) in the US, asked the WTO for help: they argued that this law was just a pretext to limit cheap imports. Considering this case, the **commission agreed that this law did not meet WTO standards and ordered its repeal**.

IMF at the same time is an international fund which main goal is maintaining the economic stability of member countries by providing short-term and long-term loans. Although the organisation was created with the purpose "to foster global monetary cooperation, secure financial stability, facilitate international trade etc." there is a lot of of criticism of the fund's activities. Critics say, that the main problem is **pro-american orientation of actions** of the fund and the ineffectiveness of recommendations in providing loans. For example, votes when making decisions on the actions of the fund are distributed in proportion of contributions: to approve the fund's decisions, 85% of the votes are required - the United States has about 17% of all votes, as a result - **USA can block any decision of the fund**. Another example of the ineffectiveness of its activities can be the case of Rwanda. In 1989, the IMF granted Rwanda a **$200 million loan** with the condition that the government will stop to support farmers, **as a result of which were a cost of living crisis and civil war**.

In conclusion, it is clear that international institutions impact on international trade is tremendous: in both good and bad way.