Global Business 3e
Chapter 5
Trading Internationally

Learning Objectives

After studying this chapter, you should be able to:

- **5-1** use the resource-based and institution-based views to answer why nations trade.
- **5-2** understand classical and modern theories of international trade.
- **5-3** realize the importance of political realities governing international trade.
- **5-4** participate in two leading debates concerning international trade.
- **5-5** draw implications for action.

WHY DO NATIONS TRADE?

In general, nations trade in order to achieve some benefit.

Typically, firms *within* nations are trading internationally, although governments sometimes engage in trade as well.

? What benefits might nations or firms within nations receive by trading internationally?

KEY TERMS IN INTERNATIONAL TRADE

Exporting

Selling abroad

Importing

Buying from abroad

Merchandise

Tangible products being traded

Service

Intangible services being traded

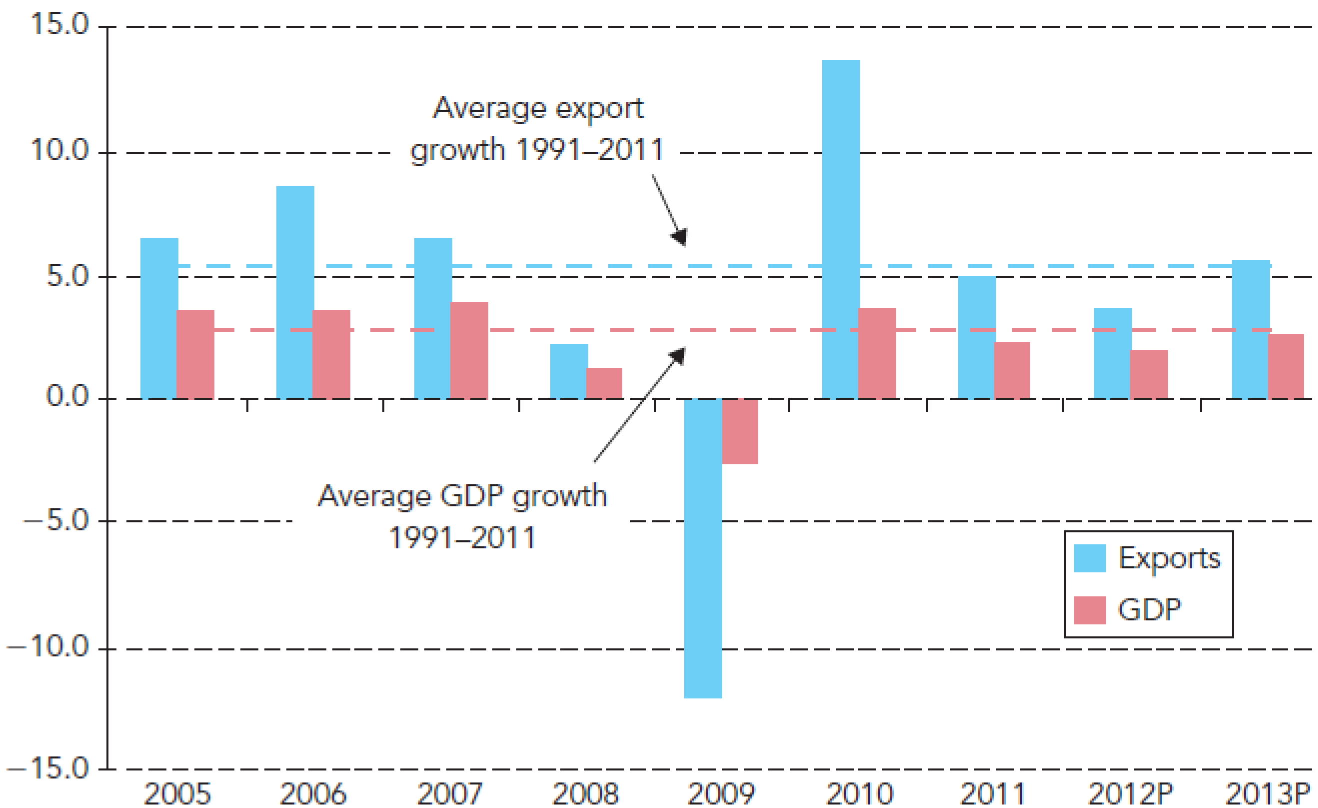
Table 5.1 **Leading Trading Nations**

	Top 10 *merchandise* exporters	Value ($ billion)	World share (%)	Annual change (%)		Top 10 *merchandise* importers	Value ($ billion)	World share (%)	Annual change (%)
1	China	1,899	10.4%	20%	**1**	United States	2,265	12.3%	15%
2	United States	1,481	8.1%	16%	**2**	China	1,743	9.5%	25%
3	Germany	1,474	8.1%	17%	**3**	Germany	1,254	6.8%	19%
4	Japan	823	4.5%	7%	**4**	Japan	854	4.6%	23%
5	Netherlands	660	3.6%	15%	**5**	France	715	3.9%	17%
6	France	597	3.3%	14%	**6**	United Kingdom	636	3.5%	13%
7	South Korea	555	3.0%	19%	**7**	Netherlands	597	3.2%	16%
8	Italy	523	2.9%	17%	**8**	Italy	557	3.0%	14%
9	Russia	522	2.9%	30%	**9**	South Korea	524	2.9%	23%
10	Belgium	476	2.6%	17%	**10**	Hong Kong, China	511	2.8%	16%
	World total	**18,215**	**100%**	**19%**		**World total**	**18,380**	**100%**	**19%**

	Top 10 *service* exporters	Value ($ billion)	World share (%)	Annual change (%)		Top 10 *service* importers	Value ($ billion)	World share (%)	Annual change (%)
1	United States	578	13.9%	11%	**1**	United States	391	10.1%	5%
2	United Kingdom	274	6.6%	11%	**2**	Germany	284	7.3%	8%
3	Germany	253	6.1%	9%	**3**	China	236	6.1%	23%
4	China	182	4.4%	7%	**4**	United Kingdom	171	4.4%	7%
5	France	181	3.9%	11%	**5**	Japan	155	4.3%	6%
6	India	148	3.6%	20%	**6**	France	141	3.6%	7%
7	Japan	143	3.4%	3%	**7**	India	130	3.4%	12%
8	Spain	141	3.4%	14%	**8**	Netherlands	118	3.1%	12%
9	Netherlands	128	3.1%	11%	**9**	Italy	115	3.0%	5%
10	Singapore	125	3%	12%	**10**	Ireland	113	2.9%	6%
	World total	**4,150**	**100%**	**11%**		**World total**	**3,470**	**100%**	**11%**

Source: Adapted from World Trade Organization, 2012, World trade 2011, prospects for 2012, press release (Appendix Tables 3 and 5), April 12, Geneva: WTO (www.wto.org). All data are for 2011.

Figure 5.1 **Growth in World Trade Outpaces Growth in World GDP (Annual % Change)**



Source: World Trade Organization, 2012, World trade 2011, prospects for 2012, press release, April 12, Geneva: WTO (www.wto.org). "P" in "2012P" and "2013P" refers to prediction.

INTERNATIONAL TRADE

Trade deficit

When a nation imports more than it exports

Trade surplus

When a nation exports more than it imports

Balance of trade

Whether a country has a trade surplus or deficit

INTERNATIONAL TRADE THEORIES

Classical trade theories

(1) Mercantilism

(2) Absolute Advantage

(3) Comparative advantage

INTERNATIONAL TRADE THEORIES

Modern trade theories

(1) Product Life Cycles

(2) Strategic trade

(3) "Diamond"

MERCANTILISM

Theory of mercantilism

Wealth of the world (measured in gold and silver) is fixed and that a nation that exports more and imports less would enjoy the net inflows of gold and silver and thus become richer; international trade is viewed as a zero-sum game

Protectionism

Idea that governments should actively protect domestic industries from imports and vigorously promote exports

ABSOLUTE ADVANTAGE

Free trade

Buying and selling of goods and services with little or no government intervention

Theory of absolute advantage

Nation gains by specializing in economic activities in which that nation has an absolute advantage

Absolute advantage

To be more efficient than anyone

else in the production of any good or service

Figure 5.2 **Absolute Advantage**

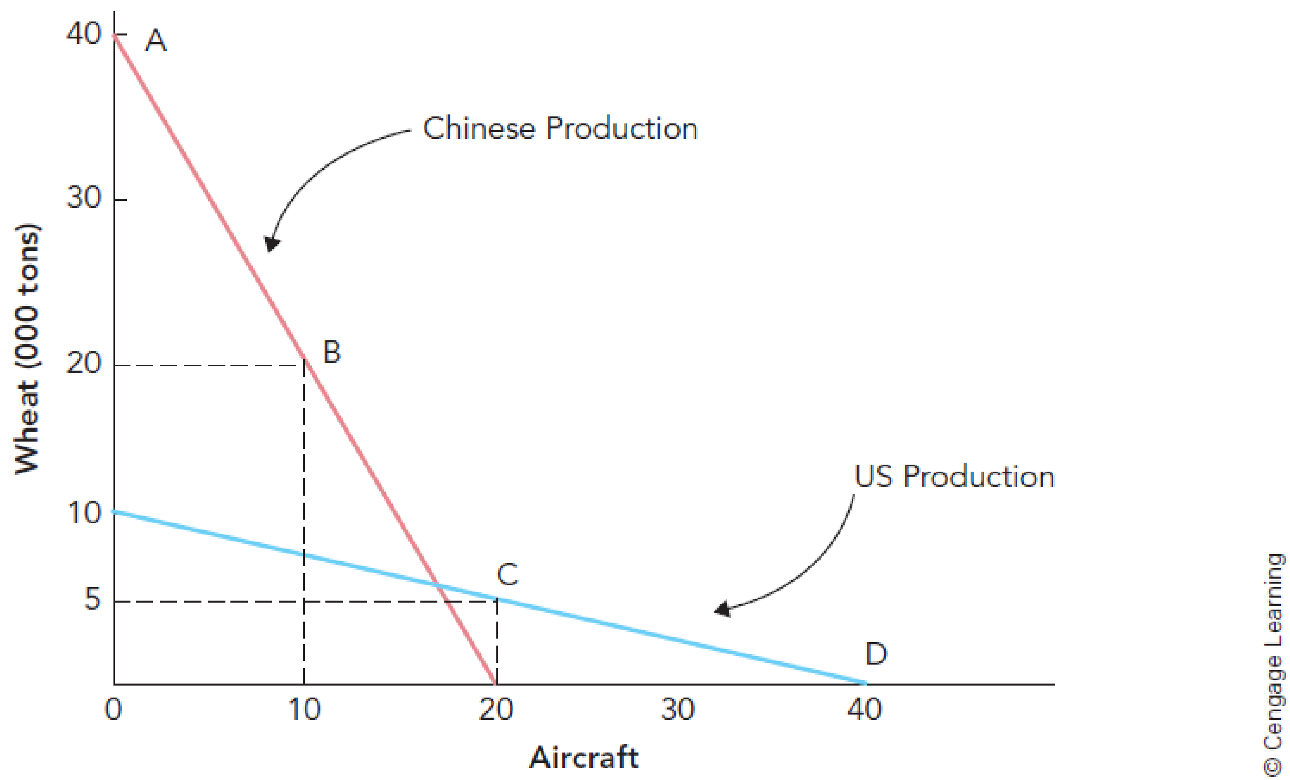


Table 5.2 Absolute Advantage

Total units of resources = 800 for each country		Wheat	Aircraft
(1) Resources required to produce 1,000 tons of wheat and 1 aircraft.	China US	20 resources 80 resources	40 resources 20 resources
(2) Production and consumption with no specialization and without trade (each country devotes *half* of its resources to each activity).	China (point B) US (point C) *Total production*	20,000 tons 5,000 tons *25,000 tons*	10 aircraft 20 aircraft *30 aircraft*
(3) Production with specialization (China specializes in wheat and produces no aircraft, and the United States specializes in aircraft and produces no wheat).	China (point A) US (point D) *Total production*	40,000 tons 0 *40,000 tons*	0 40 aircraft *40 aircraft*
(4) Consumption after each country trades one-quarter of its output while producing at points A and D, respectively (Scenario #3).	China US *Total consumption*	30,000 tons 10,000 tons *40,000 tons*	10 aircraft 30 aircraft *40 aircraft*
(5) *Gains* from trade: Increase in consumption as a result of specialization and trade (Scenario #4 versus #2).	China US	+10,000 tons +5,000 tons	0 +10 aircraft

COMPARATIVE ADVANTAGE

Nation A has an absolute advantage in production of all goods compared to

Nation B

As long as Nation B is not equally less efficient in the production of both goods, Nation B can still choose to specialize

in the production of one good in which it has comparative advantage

COMPARATIVE ADVANTAGE

Comparative advantage

Relative (not absolute) advantage in one economic activity that one nation enjoys in comparison with other nations

Opportunity cost

Cost of pursuing one activity at the expense of another activity, given the alternatives

Figure 5.3 **Comparative Advantage**

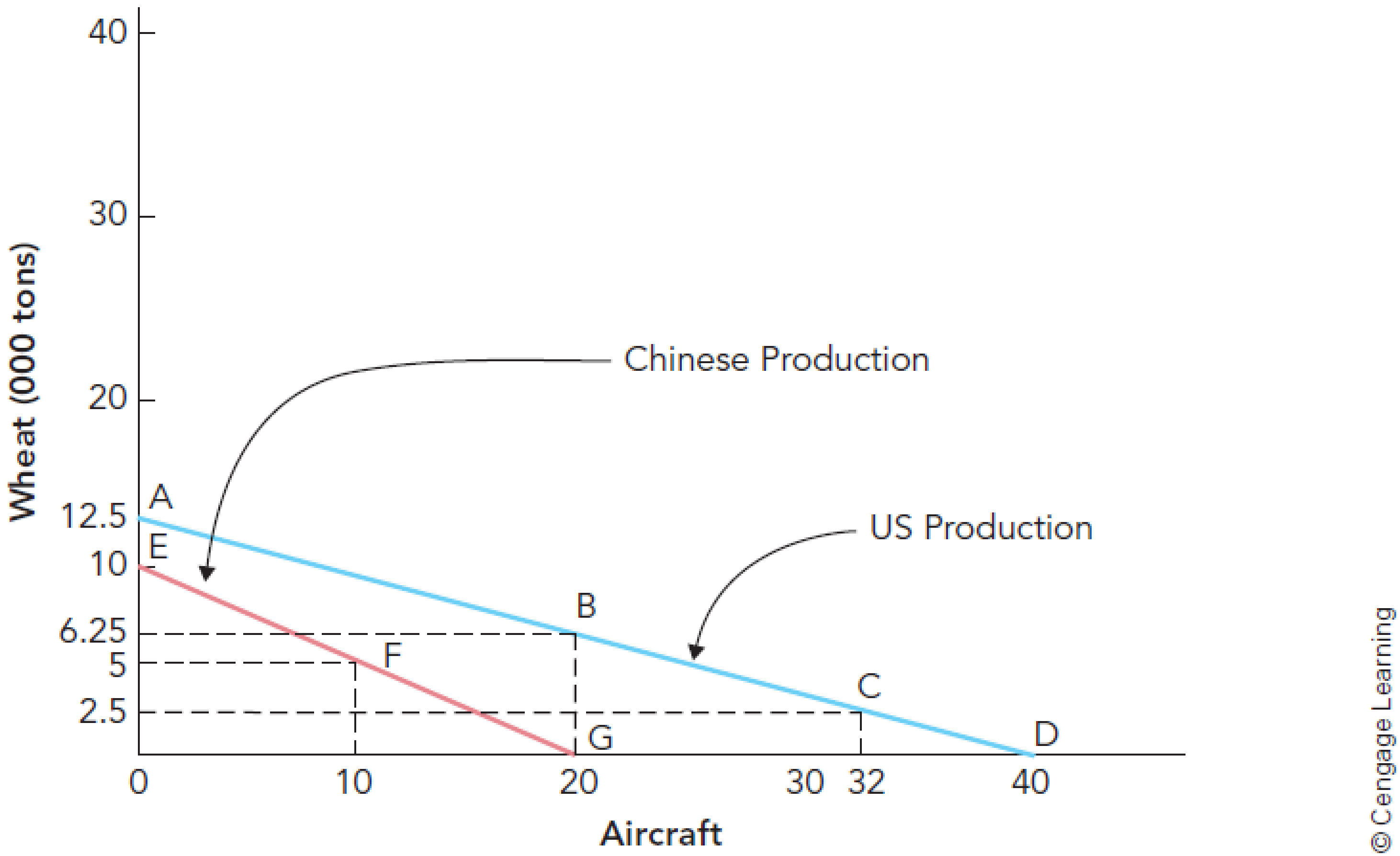


Table 5.3 **Comparative Advantage**

Total units of resources = 800 for each country		Wheat	Aircraft
(1) Resources required to produce 1,000 tons of wheat and 1 aircraft.	China US	80 resources 64 resources	40 resources 20 resources
(2) Production and consumption with no specialization and without trade (each country devotes *half* of its resources to each activity).	China (point F) US (point B) *Total production*	5,000 tons 6,250 tons *11,250 tons*	10 aircraft 20 aircraft *30 aircraft*
(3) Production with specialization (China devotes all resources to wheat, and the United States devotes one-fifth of its resources to wheat and four-fifths of its resources to aircraft).	China (point E) US (point C) *Total production*	10,000 tons 2,500 tons *12,500 tons*	0 32 aircraft *32 aircraft*
(4) Consumption after China trades 4,000 tons of wheat for 11 US aircraft while producing at points E and C, respectively (Scenario #3).	China US *Total consumption*	6,000 tons 6,500 tons *12,500 tons*	11 aircraft 21 aircraft *32 aircraft*
(5) *Gains* from trade: Increase in consumption as a result of specialization and trade (Scenario #4 versus #2).	China US	+1,000 tons +250 tons	+1 aircraft +1 aircraft

SOURCE OF ABSOLUTE AND COMPARATIVE ADVANTAGES

Factor endowment

Extent to which different countries possess various factors of production such as labor, land, and technology

Factor endowment theory (Heckscher-Ohlin theory)

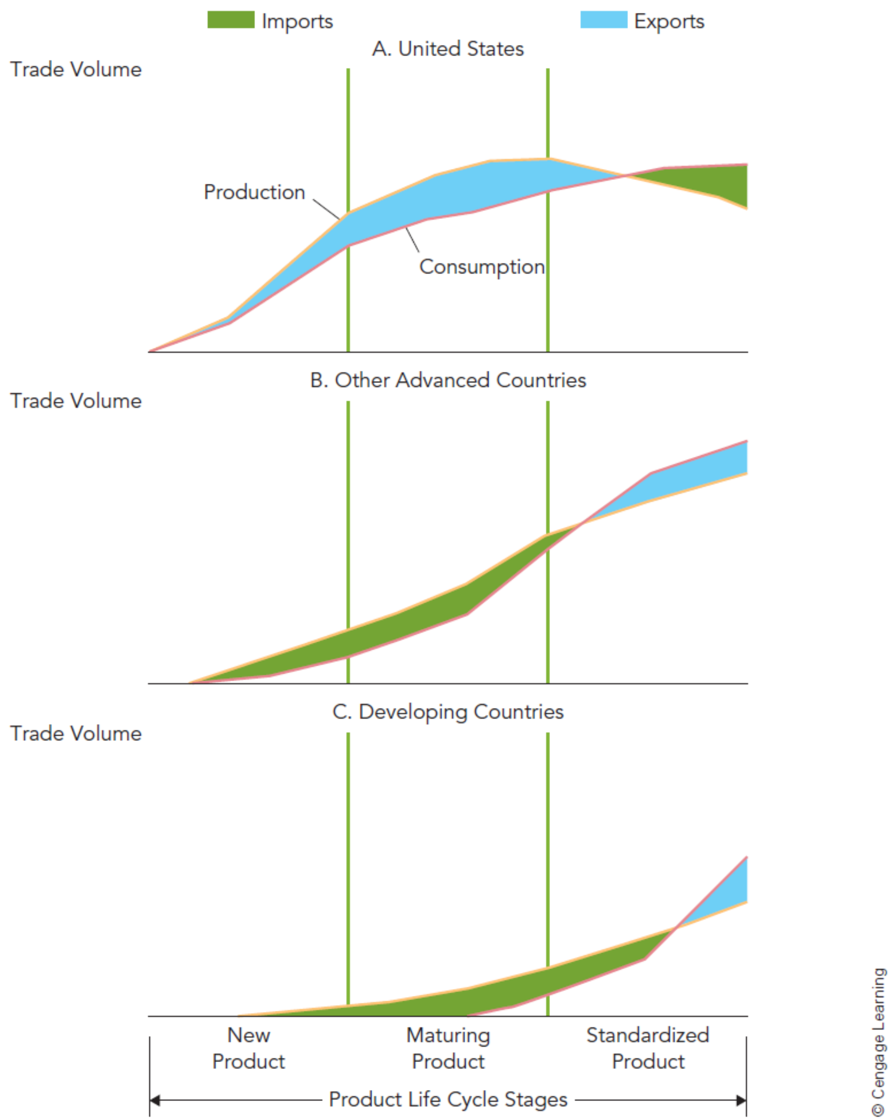
Nations will develop comparative advantages based on their locally abundant factors

PRODUCT LIFE CYCLE

Product life cycle theory

The first *dynamic theory to* account for changes in the patterns of trade over time

Figure 5.4 **Theory of Product Life Cycles**



STRATEGIC TRADE

Strategic trade theory

Strategic intervention by governments in certain industries can enhance their odds for international success

First-mover advantage

Advantages that first entrants enjoy and do not share with late entrants

? What advantages might a firm enjoy by being the first mover into a market?

Figure 5.5 **Entering the Very Large, Super-Jumbo Market?**

Panel A. Without Government Subsidy (Outcome = Airbus, Boeing)

Airbus \ *Boeing*	Enter	Don't Enter
Enter	(Cell 1) –$5 billion, –$5 billion	(Cell 2) $20 billion, 0
Don't Enter	(Cell 3) 0, $20 billion	(Cell 4) 0, 0

Panel B. With $10 Billion Subsidy from European Governments (Outcome = Airbus, Boeing)

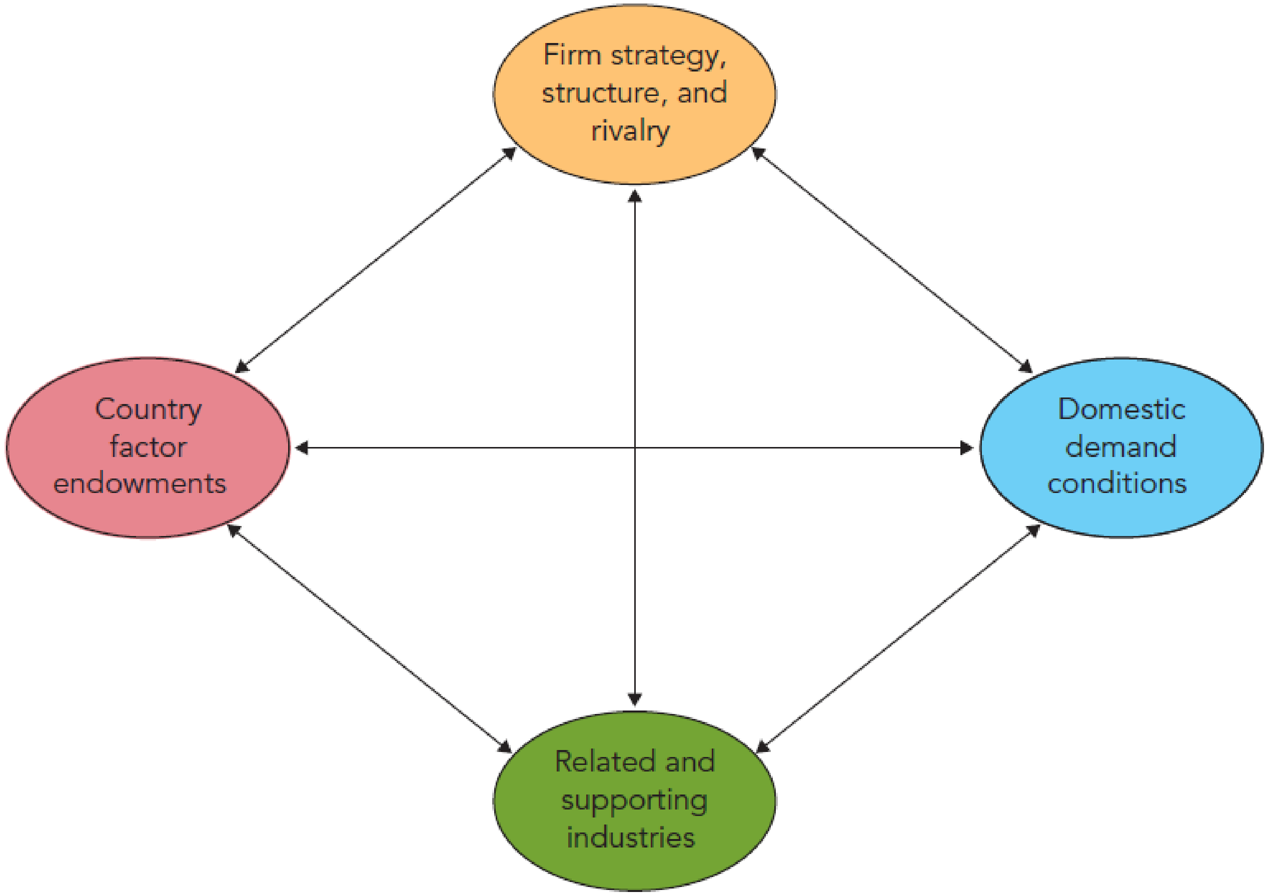
Airbus \ *Boeing*	Enter	Don't Enter
Enter	(Cell 1) $5 billion, –$5 billion	(Cell 2) $30 billion, 0
Don't Enter	(Cell 3) 0, $20 billion	(Cell 4) 0, 0

NATIONAL COMPETITIVE ADVANTAGES OF INDUSTRIES

Theory of national competitive advantage of industries (diamond theory)

Certain industries (but not others) within a nation are competitive internationally

Figure 5.6 **National Competitive Advantage of Industries: The Porter Diamond**



Source: M. Porter, 1990, The competitive advantage of nations (p. 77), *Harvard Business Review*, March–April: 73–93. Reprinted with permission.

Table 5.4 Theories of International Trade: A Summary

Classical theories	Main points	Strengths and influences	Weaknesses and debates
Mercantilism (Colbert, 1600s–1700s)	• International trade is a zero-sum game—trade deficit is dangerous. • Governments should protect domestic industries and promote exports.	• Forerunner of modern-day protectionism.	• Inefficient allocation of resources. • Reduces the wealth of the nation in the long run.
Absolute advantage (Smith, 1776)	• Nations should specialize in economic activities in which they have an absolute advantage and trade with others. • By specializing and trading, each nation produces more and consumes more. • The wealth of all trading nations, and the world, increases.	• Birth of modern economics. • Forerunner of the free trade movement. • Defeats mercantilism, at least intellectually.	• When one nation is absolutely inferior than another, the theory is unable to provide any advice. • When there are many nations, it may be difficult to find an absolute advantage.
Comparative advantage (Ricardo, 1817; Heckscher, 1919; Ohlin, 1933)	• Nations should specialize in economic activities in which they have a comparative advantage and trade with others. • Even if one nation is absolutely inferior than another, the two nations can still gainfully trade. • Factor endowments underpin comparative advantage.	• More realistic guidance to nations (and their firms) interested in trade but having no absolute advantage. • Explains patterns of trade based on factor endowments.	• Relatively static, assuming that comparative advantage and factor endowments do not change over time.

Modern theories			
Product life cycle (Vernon, 1966)	• Comparative advantage first resides in the lead innovation nation, which exports to other nations. • Production migrates to other advanced nations and then developing nations in different product life cycle stages.	• First theory to incorporate dynamic changes in patterns of trade. • More realistic with trade in industrial products in the 20th century.	• The United States may not always be the lead innovation nation. • Many new products are now launched simultaneously around the world.
Strategic trade (Brander, Spencer, Krugman, 1980s)	• Strategic intervention by governments may help domestic firms reap first-mover advantages in certain industries. • First-mover firms, aided by governments, may have better odds at winning internationally.	• More realistic and positively incorporates the role of governments in trade. • Provides direct policy advice.	• Ideological resistance from many "free trade" scholars and policy makers. • Invites all kinds of industries to claim they are strategic.
National competitive advantage of industries (Porter, 1990)	• Competitive advantage of different industries in different nations depends on the four interacting aspects of a "diamond." • The four aspects are (1) factor endowments, (2) domestic demand, (3) firm strategy, structure, and rivalry, and (4) related and supporting industries.	• Most recent, most complex, and most realistic among various theories. • As a multilevel theory, it directly connects research on firms, industries, and nations.	• Has not been comprehensively tested. • Overseas (not only domestic) demand may stimulate the competitiveness of certain industries.

REALITIES OF INTERNATIONAL TRADE

Tariff barrier

Means of discouraging imports by placing a tariff (tax) on imported goods

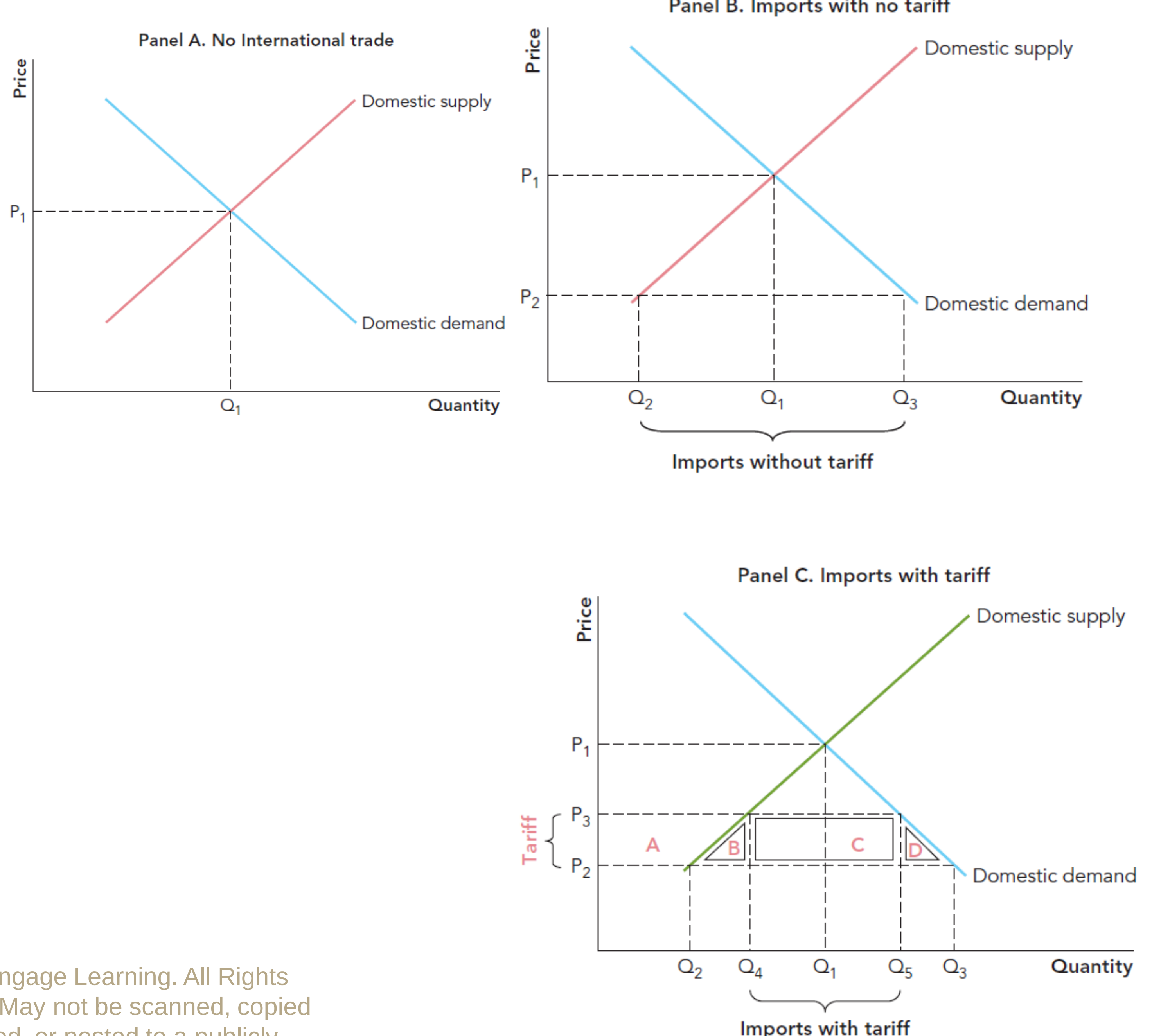
Import tariff

Tax imposed a good brought in from another country

Deadweight cost

Net losses that occur when import tariffs are imposed

Figure 5.7 Tariff on Rice Imports in Japan



NONTARIFF BARRIERS (NTBs)

Nontariff barrier (NTB)

Discourages imports using means other than taxes on imported goods

NONTARIFF BARRIERS (NTBs)

Import quota

Restriction on the quantity of a good that can be brought into a country

Voluntary export restraint (VER)

Exporting countries *voluntarily* agree to restrict their exports

Local content requirement

Rules stipulating that a certain proportion of the value of the goods made in one country must originate from that country

NONTARIFF BARRIERS (NTBs)

Administrative policy

Bureaucratic rules that make it harder to import foreign goods

Antidumping duty

Costs levied on imports that have been "dumped" (selling below costs to "unfairly" drive domestic firms out of business

ARGUMENTS AGAINST FREE TRADE

Infant industry argument

Young domestic firms need government protection because they stand no chance of surviving and will be crushed by mature foreign rivals

ARGUMENTS AGAINST FREE TRADE

Trade embargo

Politically motivated trade sanctions against foreign countries to signal displeasure

Table 5.5 **Debate on the US Trade Deficit with China**

US trade deficit with China is a huge problem	US trade deficit with China is not a huge problem
Naïve trader versus unfair protectionist (in China) • The United States is a "naïve" trader with open markets. China has "unfairly" protected its markets.	*Market reformer versus unfair protectionist (in the US)* • China's markets are already unusually open. Its trade volume (merchandise and services) is 75% of GDP, whereas the US volume is only 25%.
Greedy exporters • Unscrupulous Chinese exporters are eager to gut US manufacturing jobs and drive US rivals out of business.	*Eager foreign investors* • Two-thirds of Chinese exports are generated by foreign-invested firms in China, and numerous US firms have invested in and benefited from such operations in China.
The demon who has caused deflation • Cheap imports sold at "the China price" push down prices and cause deflation.	*Thank China (and Wal-Mart) for low prices* • Every consumer benefits from cheap prices brought from China by US firms such as Wal-Mart.
Intellectual property (IP) violator • China is a major violator of IP rights, and US firms lose $2 billion a year.	*Inevitable step in development* • True, but (1) the US did that in the 19th century (to the British), and (2) IP protection will improve in China.
Currency manipulator • The yuan is severely undervalued (maybe up to 40%), giving Chinese exports an "unfair" advantage in being priced at an artificially low level.	*Currency issue is not relevant* • The yuan is somewhat undervalued, but (1) US and other foreign firms producing in China benefit, and (2) yuan appreciation will not eradicate US trade deficit.
Trade deficit will make the United States poorer • Since imports have to be paid, the United States borrows against its future with disastrous outcomes.	*Trade deficit does not cause a fall in the US standard of living* • As long as the Chinese are willing to invest in the US economy (such as Treasury bills), what's the worry?
Something has to be done • If the Chinese don't do it "our way," the United States should introduce drastic measures (such as slapping 20%–30% tariffs on all Chinese imports).	*Remember the gains from trade argued by classic theories?* • Tariffs will not bring back US jobs, which will simply go to Mexico or Malaysia, and will lead to retaliation from China, a major *importer* of US goods and services.

Sources: Based on (1) *BusinessWeek*, 2004, The China price, December 6: 102–112; (2) *BusinessWeek*, 2009, Free trade in the slow lane, September 21: 50; (3) *China Business Review*, 2008, US exports to China hit new high, September-October: 36–39; (4) *Economist*, 2005, From T-shirts to T-bonds, July 30: 61–63; (5) G. Locke, 2011, A message from the US Ambassador to China, *China Business Review*, October: 16; (6) O. Shenkar, 2005, *The Chinese Century*, Philadelphia: Wharton School Publishing.

CLASSICAL THEORIES VS NEW REALITIES

Classical theorists and their modern-day disciples argue that the US and India trade by tapping into each other's comparative advantage:

India leverages its abundant, high-skill, and low-wage labor

Americans will channel their energy and resources to higher skill, higher paying jobs

Regrettably, certain Americans will lose jobs, but the nation as a whole benefits?

? Are the theories still valid?