Suite 106

THEORY OF INTERNATIONAL TRADE

106.01 THE MERCANTILIST

Trade Theory is used to simplify reality so that the basic elements of the topic can be understood.

During the Industrial Revolution where the economy was best described as mercantilist and was based upon certain principles and beliefs:

Governments, especially those building colonial empires, needed to control trade for power. This also provided security and a means to secure the raw materials required to support their colonial empires.

Therefore, if a country could export more than it could import and collect the difference in gold it would grow wealthier. This was typical of the trading companies owned by the Monarchies and who were granted monopolies in the New World. Such was the case with the British Empire and their control over the Dutch East India Company and The Hudson's Bay Company.

It was generally believed that your country could benefit if you were able to export more than import because the amount of wealth in the world was fixed. In order to achieve this result governments encouraged trade but with restrictions on imports to ensure that a favourable balance was achieved. These restrictions were in the form of Duties and taxes.

It was believed that in exporting as much as possible and restricting imports the country could control much of their gold and silver and were less concerned as to the consumer goods needed.

Mercantilists believed the accumulation of gold in one particular country would lead to higher prices and more importation of goods and less exporting. This is still true today in that strong currencies lead to higher prices for exports and this leads to equilibrium.

106.02 FIRST MODERN ECONOMIST

There was a departure from the generally accepted ideas of the time which occurred in 1776 when Adam Smith wrote "Wealth of Nations", considered the first economics book. "Not gold that defined a countries wealth but the quality of life of its citizens." Smith was better known as the first capitalist and the 'First Modern Economist'. It was his belief that the government that did the least to interfere with business was the most effective. This theory is true today and especially in the United States. The Capitalist who gained power after him were just as disdainful of the working class as the Monarchs were in that he did not believe that money should be spread out more evenly.

106.03 ABSOLUTE ADVANTAGE

The theory of Absolute Advantage is based on an assumption that each country would specialize and gain an absolute competitive advantage in trade in a particular product. If a country specialized in what it does best then it could make more and trade for the other commodity. If the other country also specialized then it could trade for what it wanted. If both countries could make more then in fact more wealth is crated and more goods mean lower prices and everyone can live better. Therefore, the government should do nothing to restrict trade.

All of this is based on an inherent ability of one country having an ability to produce better or cheaper goods through cheaper labor and/or material resources.

106.04 PORTER'S THEORY

International trade is a function of how a country:

- Uses its factors of production Creativity and adaptability which are more important than abundance
- Character of its market. Demand condition. Lots of competition leads to better products. Sophisticated and demanding customers help make local manufacturers more competitive.
- Related and supporting industries (transportation etc.)
- Strategy, structure rivalry.

All four components are usually needed to positively offset competition from countries better endowed with resources. Porter argues that government intervention is a good thing in certain areas.

106.04 DIFFERENCES IN TRADE THEORY

There are two obvious differences between old and modern trade theory:

- Labor is not a major factor of production
- Capital is absolutely mobile.