Absolute Advantage

Adam Smith

Assuming that Labor is the only scarce factor for production, countries can increase their well being by producing only those goods that they are able to produce at least cost.

Labor cost (Hours) of Production for one unit

	Mutton	Beer
A	20	40
B	40	20

Comparative Advantage
David Ricardo

Assumptions

There are two countries A and B, *both of which produce* mutton and beer

Returns to scale are *constant*

	Mutton		Bear
A	50 KG	or	25 bottles
B	60 KG	or	150 bottles

Factors of production used in producing these two goods (say land) can be *transformed without cost* from producing mutton to producing beer and vice versa

B has an absolute advantage **in the production of both goods**

Specifically, if A used all its factors of production **(say land),**

A could produce	50 kg of mutton	or	25 bottles of bear
Similarly, B could produce	60 kg *of mutton*	or	150 bottles *of bear*

For A, beer / mutton = 25 / 50 = 0.5

For B, beer / mutton = 150 / 60 = 2.5

Therefore, Mutton is more expensive in B than in A

Pre-trade production

	Mutton (Kg)	*Beer (bottle)*
A	**40**	**5**
B	**20**	**100**
Total	**60**	**105**

Let, both countries agree to trade one bottle of beer per one kg of mutton and let country ‘A’ produce only mutton and both trade 10 kg of mutton and 10 bottles of beer

Post-trade Economy

	Mutton			Beer		
	Domestic		Imports	Domestic		Imports-
A	40		0	0		10
B	16		10	100		0
Total	56	+	10	100	+	10
		66			110	

Intuitive understanding

A person, good as a CEO and as a typist

Where will he/ she invest time?

Assumptions in Ricardo’s Model

- Production technologies – constant returns to scale
- Perfectly Competitive market structure
- No Technological Innovations and spillovers

Hecksher–Ohlin Theory

- Factor endowments and comparative advantage
- A country exports those goods that use intensively its relatively abundant factor of production.

Assumptions

- **Different goods have different *factors intensities***
  Textiles -> labor intensive,
  Semiconductors -> capital intensive
- ***Countries differ* with respect to their factor endowment**
  India – natural resources(1900s)
  Britain – capital and technology
- **Decreasing return to scale (*instead of constant return to scale*)**
- **Endowments are *given***
  (*but they can be created through innovation*)
- **Endowments are *static* in nature**

Leontief Paradox

U.S. exports were *less capital intensive* than U.S. imports.

World Trade Organization

ITO:1944
GATT:1948

Arguments for Free Trade & Investment

Promotes growth and enhances economic welfare by

- Simulating more efficient utilization of factor endowments of different regions
- Greater specialization of economy
- Break domestic monopolies
- Free & fair competition
- Enable people to obtain goods from efficient sources of supply at cheaper prices
- Making available more variety of goods and services

Barriers to trade

Encourage local production

Protect local jobs

Protect infant industries

Reduce balance of payment problem

Promote export activity

Prevent dumping from other countries

Promote political objective

Commonly used barriers

Price-based barriers *(high tariffs)*
Quantity limits *(Examples – Steel? Textiles?)*
International price fixing *(OPEC – cartel)*

Non-tariff barrier (Bureaucratic red tape, slow processing of import permits)

Financial limits *(Exchange control on amount, limit on amount carried by travelers, Fixed rates of exchange, currency appreciation)*

Foreign investment control

Wait a Minute

In which global framework will all these work?

Perfect Market Competition

Static Equilibrium Economics

Firm level Theoretical Explanations

Transaction Cost Theory

Institutional Theories

Internalization Theory

IPLC

OLI Eclectic Paradigm

Other Strategic Frameworks

(Standardization, Market Information–Commitment, **CAGE**, Complementation)

Transaction Cost Theory

Ronald Coase

1. The transaction costs of the market include the cost of *discovering relevant prices and arranging contracts* for each market transaction.

2. The existence of *such costs* means that whenever transactions can be organized and carried at a lower cost within the firm than through the market, they will be *internalized and undertaken* by the firm itself.

3. Firms will internalize transactions until the *marginal cost of doing so exceeds the marginal revenue.*

4. This theory originally focused on *multi-plant domestic firm* rather than the international operations of firms.

5. It suggests that the market is *costly and inefficient* for undertaking certain types of transactions.

6. It assumes that firms and markets represent *alternate methods* of organizing production.

7. Ignores the strategic aspect of in-house production of certain items even if the market can produce at lower cost.

Transaction Cost Theory

Oliver Williamson

(1975, 1981, 1985)

Extended and refined this theory by relating transaction cost to three factors:

Bounded rationality: refers to the impossibility of accessing to full information and the decisions are made at incomplete information

Opportunism: It refers to the tendency of some people to cheat or misrepresent

Asset specificity: It reflects the extent to which types of transaction, in order to be carried out, necessitate investment in material and intangible assets (such as knowledge)

Internalization Theory

1. Internalization is concerned with *imperfections* in the intermediate product markets
2. Market imperfections *generate transaction costs* for the firm
3. By bringing interdependent activities under *common ownership* and control, a firm *reduces the transaction costs* in its business

4. It proposes that firms *expand across borders* because the *transaction costs* incurred in international intermediate product markets can be *reduced* by internalizing these markets within the firm

5. It can be used to explain the patterns of both *vertical integration* (Production, Marketing, R&D) and *horizontal integration* across borders

When applied to International business

Vertical Integration: Export, Overseas Production, Overseas Distribution

Horizontal Integration: Selling through Exclusive and Non Exclusive Retail outlets

What's Missing?

- A theory of *market failure* rather than of firm success (Growth of Firm)

- It is preoccupied with the cost of *organizing transactions* in the markets and it does not consider the organizing or the management costs incurred by firms (Demsetz 1988)

- Collusion & Market Power – *Asymmetry in entrepreneurship, capital, information, …*

Other Explanations

IPLC

OLI Eclectic Paradigm

Other Strategic Frameworks

(Standardization, Market Information–Commitment, **CAGE**, Complementation)