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1. Learning Outcomes

After studying this module, you shall be able to

- Understand the concept of modern theories of trade.
- Identify the changing dimensions of trade that explain the progress from traditional to modern theories of trade.
- Learn about Country-Similarity Theory.
- Analyze the relocation of production through various stages of product's life cycle.

2. Introduction

Theories of Trade

The theories of trade are categorized into two parts: Traditional Theories and Modern Theories of Trade. The traditional theories include Mercantilism, Absolute Advantage, Comparative Advantage and Heckscher-Ohlin Theory which emphasize on trade between countries. These theories are considered country-specific. For example: if a country is specialized in producing a product for which it is getting an absolute or comparative advantage, then it will get a similar advantage by exporting that product and importing another product from other country. As against traditional theories, modern theories of trade which are considered firm-specific emerged after World War II. These theories basically evolved due to the growing importance of multinational corporations in post-war international economy.

Now the focus has been shifted from traditional, country-based trade theories to modern, firm based theories. This is because expansion of MNCs was not addressed by classical economists. Moreover, intra-industry trade was not taken into account, which refers to trade between two countries of goods produced in the same industry. Product and service factors, including brand loyalty, technological innovation and better quality are incorporated by modern theories for understanding trade flows.

These theories are categorized as follows:

Modern Theories of Trade

- ***Country Similarity Theory***
- ***Product Life Cycle Theory***
- ***New Trade Theory***
- ***Porter's National Diamond: Competitive Advantage***

3. Changing Dimensions- From Traditional to Modern Theories of Trade

Comparison between Traditional and Modern Theories of Trade

Traditionally, trade is explained by Adam Smith through Absolute Advantage and by Ricardo through Comparative Advantage. But in case of Heckscher-Ohlin theory, supply of factors basically explain and control trade which arise from locally abundant factor endowments.

There are some dimensions of trade which explained the progress from classical to modern theories of trade:

1. The traditional theories are considered country-specific whereas modern theories are considered firm-specific.
2. The concept of traditional theories is explained in terms of labour theory of value while the phenomenon of modern theories is based on general equilibrium theory of value.
3. One-factor (labour) model is presented by classical economists while the modern theory is more realistic and is presented by multi-factor (labour and capital) model.
4. Classical theories are more useful in explaining the trade of homogenous, undifferentiated products. Example: agricultural goods, aluminum, crude oil etc. On the other hand, Modern theories are more useful in understanding trade of heterogeneous, differentiated products. Example: personal care products, electronics etc.
5. The traditional theories put more emphasis on gains from trade but the modern theory emphasizes on trade structure and forms the basis of trade.
6. Traditional economists aim at improving the welfare of every individual, not making anyone worse off. However, this assumption does not hold in case of modern theories.

7. The traditional theory is recognized as a single-market theory of value whereas the modern theory is also known as multi-market theory of value.
8. Differences in comparative advantage are attributed by classical economists to differences in production functions. In contrast to classical economists, there are similar production functions in modern theories. These production functions attribute the differences in comparative advantage to factor proportion differences which exist between countries.

4. Country Similarity Theory

Many difficulties arise in providing the empirical evidence of factor proportions theory in the 1960s which lead to find for new determinants of trade between countries. Hence, Staffan Linder, a Swedish economist, proposed a new framework called, Country Similarity Theory. Initially, he made efforts to explain intra-industry trade. This theory explained that consumers in countries might have similar preferences if they are exposed to the same development stage. This is one of the firm-based theories which signify that companies should initially produce for their domestic use. Later when companies start exporting, they explore that the markets which are similar in terms of customer preferences to their domestic counterpart, will provide them the best for success.

Linderøs work focused on the customer preferences that is the demand side rather than on the production or supply side. He also explained that mostly trade in manufactured goods will occur between countries which have same per-capita income. Therefore, this will result in common intra-industry trade.

Further, he categorized international trade into two parts: primary products that are natural resource products and manufactures. This theory proposed that trade in primary products is explained by differences in factor endowments but not in manufactures. Rather these manufactured exports are determined by internal demand. However, developed nations examined international trade in manufactures because these nations are specialized in exporting goods which they manufacture domestically. Andonly those goods are manufactured domestically by them for which there is greater demand at home.

For instance, if two countries like U.S.A and U.K. have identical demand preferences, then their consumers and investors want to look for same products having identical quality and hence, they fulfill their demand of having the same goods. This shows preference-similarity which encourages trade between these industrialized countries.

Figure 1 shows similarity between countries in terms of their location, culture and also considering their legal aspects.

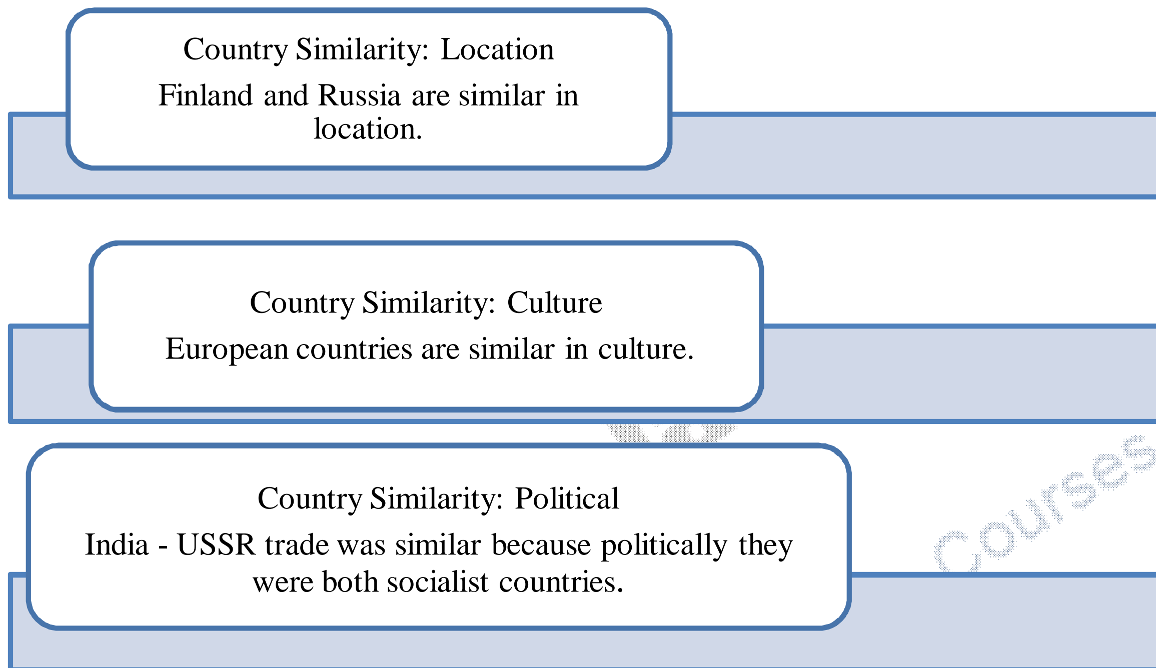

Figure 1

He further raised an argument to find whether per capita income is the most important one. Countries having high per capita income will demand high quality goods (consumer goods or capital goods). On the other hand, countries having low per capita income will demand low luxury goods. Hence, countries that gain find it profitable to export their products in other countries where the demand for those products is high. Similarly, manufactured exports of the poor countries should look for reputed markets in other poor countries having identical demand structures.

Moreover, this firm-based theory plays an important role in understanding trade in products where brand loyalty, reputation of a product, its quality, etc are significant factors in consumerøs buying process.

5. Product Life Cycle Theory

Product-Life Cycle Theory was developed by Raymond Vernon of the Harvard Business School in the mid 1960s. A new approach has been suggested in which various changes will occur in the newly established product in the market and then get standardized in production. The main proposition of the theory is to locate production shifts when products move through various stages of the product-life cycle. Vernon significantly diverged from traditional theories and put emphasis on the product rather than factor proportions.

A three stage model is proposed by Vernon to demonstrate the behavior of U.S. exports of manufactures shown in Figure 2. The main assumption of this model is that the effects which occur in exports due to innovation and creativity in the product are undermined by technological diffusion and lower costs abroad.

This model further assumed United States as an innovative country firm which initially specialized in exporting product to the other advanced countries.

Vernonøs theory was based on the proposition that most of the worldøs new products had been produced by United States firms and then sold initially in the home market. But it doesnøt mean that the product should be produced in the United States itself. There might be a possibility of producing that product somewhere else at a lower cost and then exported back to the United States. Further, the argument rose that mostly products were initially established in U.S. Simultaneously, assuming the uncertainty and risk in introducing newly established products, the firms found better to set production facilities apparently close to the market.

The three stages are as follows:

- New Product Stage
- Maturing Product Stage
- Standardized Product Stage

5.1 Stages of Product-life Cycle

5.1.1 Stage I: The New Product

Initially in the life cycle of a new product, large amount of capital and skilled labour are necessary for research and development. In this stage, the demand is growing rapidly in the United States whereas the demand in other advanced countries is lacking as compared to highly advanced countries.

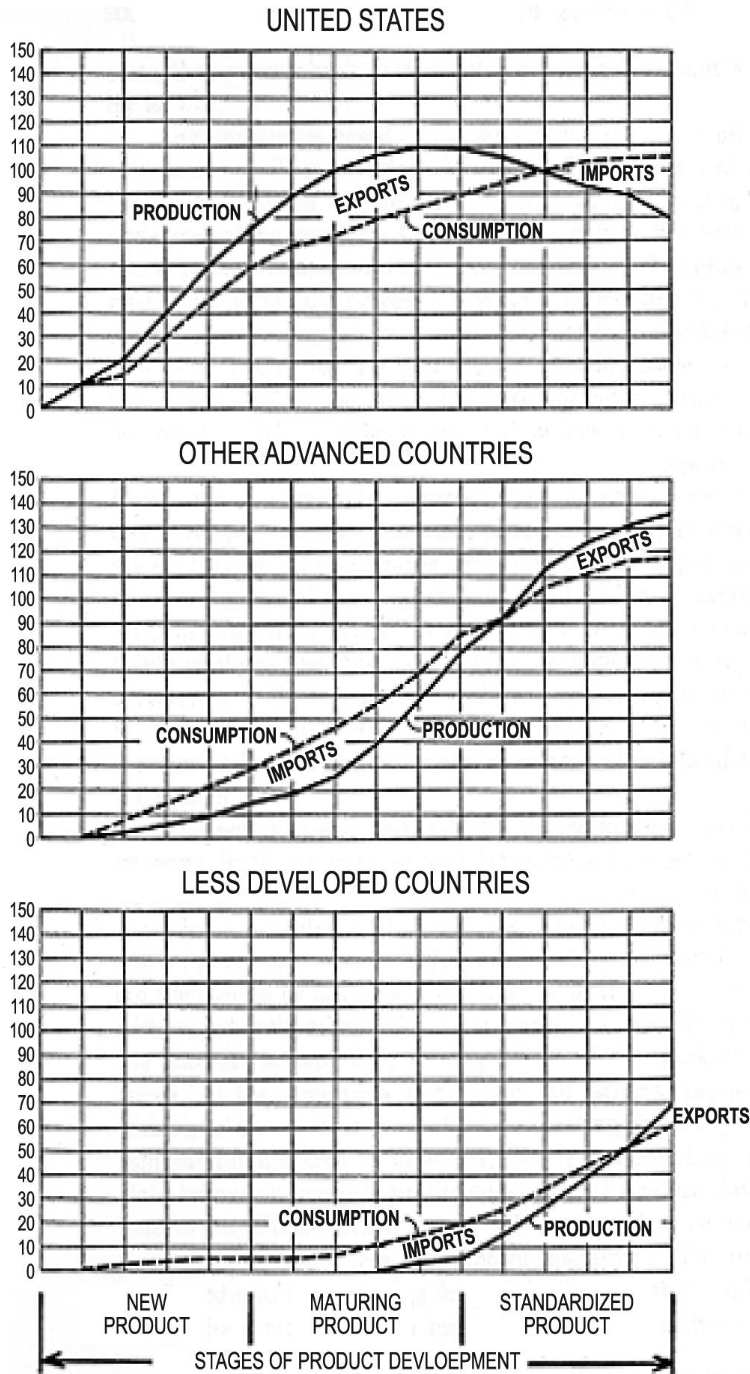

Figure 2

The product is considered non-standardized due to which it requires flexibility. Thus, production costs are quite high. It is also useless for other advanced countries to produce the product on their own because of limited demand. Hence, it is worthwhile for them to export the product from the United States.

5.1.2 Stage II: The Maturing Product

In this stage, the product is becoming increasingly standardized due to expansion in production. The product started growing in other advanced countries. Thus, foreign producers might get benefit of producing product for their home markets. But the demand for highly skilled labour diminishes because of fall in need for flexibility in design. U.S. firms also might establish production facilities in advanced countries. Hence, this will lower the need for exports from the U.S. firms.

5.1.3 Stage III: The Standardized Product

In the final stage, the product becomes completely standardized and price is considered as the main tool. This encourages cost to play an important role in the competitive process. Hence, the country started producing with cheap unskilled labour having access to large amount of capital. The product made progress and have become profitable for the innovative firm. But now the countryøs advantage has shifted in its location of production because the technology of the innovating firm has matured. Due to cheap labour costs, firms of advanced countries are now able to export to the U.S. firm. Hence, there has been a shift in the production from high-cost sites to low-cost sites in other advanced countries and then to developing countries. Thus, the process continues where advanced countries acquired production advantage over U.S. firms and on the same side, advanced countries are losing advantage over developing countries.

Therefore, innovating firmøs country becomes a net importer of the product whereas developing countries become net exporters of the product.

5.2 Evaluation of Product Life Cycle Theory

In Product life cycle theory, it is noted that labour and capital levels identify and analyze the countries production, consumption, export and import. Firms do not play major role in analyzing them. The switching of production showed changing patterns of trade but did not result in loss of market share, profitability or competitiveness of firms. The countryøs comparative advantage might change.

This firm-based theoryplays a crucial role in explaining international investment and put greater emphasis in analyzing the impact of technology on product costs. The theory not only able to recognize the capital mobility across countries but it also made efforts to switch the locus of production from country to the product. Hence, it becomes necessary to match the product by its maturity stage with its location of production so as to analyze competitiveness.

However, Vernonøs theory holds true during U.S. global dominance (1945-1975) because Vernonøs argument regarding most products developed in United States seems ethnocentric. But it has limited relevance in the modern world. This theory has various limitations:

1. Vernonøs theory focuses on technology-based products which mostly experience modifications in production process as they reached the maturity stage. However, it does not take into consideration either resource-based products or services that are not recognized by stages of maturity.

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2. This theory is more appropriate for products which eventually fall victim to mass production and therefore cheap labour forces.

   Though the theory seems of limited relevance but all other things considered, the theory aimed at breaching a gap between traditional trade theories and modern trade theories in which mobility of capital, technology, information and firms is better than classical theories.

6.Summary

- Modern theories play an important role in explaining in explaining the pattern of international trade. In contrast to traditional theories, these theories are recognized as firm-specific which emerged after World War II.
- Evolution of these theories is basically due to rapid growth of multinational corporations in post-war international economy.
- The fundamental reason for switching from traditional to modern theories is basically because of MNCs expansion and intra-industry trade that were not taken into account by traditional theories.
- Modern-Firm based theories are categorized as: Country- Similarity Theory, Product-Life Cycle Theory, Porterøs National Competitive Advantage Model and New Trade Theory.
- Dimensions of trade have been taken into account to distinguish between traditional and modern theories of trade.
- All theories of trade examine that why it is beneficial for a country to engage in international trade but modern theories of trade forms the basis of trade.
- Newer theories of trade can have assurance of having comparative advantage, but the source of this comparative advantage is more subtle. Sometimes, this does not even exist in autarkic situation (closed economy) but helps in developing open trade.
- Country Similarity Theory was developed by Swedish Economist, Staffan Linder in 1961 which states that trade of manufactured goods should occur between countries having similar per capita income. The underlying assumption of this theory is that countries having similar per capita income will not have different consumer tastes and preferences. Hence, the theory asserts homogeneity in this regard.
- Raymond Vernonøs Product Life Cycle Theory suggested that pattern of international trade is analyzed when a new product is introduced. Its relevance in the modern world is limited. According to this theory, a shift in trade flow of a product goes through three stages: New Product Stage, Maturing Product Stage and Standardized Product Stage.
- The consequence of this firm-based theory is that overtime an innovating firm becomes the net importer and developing countryøs firm becomes the net exporter.
- There are, however, some exceptions that examine the impact of this theory on productøs manufacturing trade. Products having short life cycle, luxury products where costs donøt matter, products requiring specialized knowledge, differentiated products will experience less, if any, impact of a life-cycle stage.