Theories of International Trade

International trade has a rich history starting with the barter system being replaced by Mercantilism in the 16th and 17th Centuries. The 18th Century saw the shift towards liberalism. It was in this period that Adam Smith, the father of Economics wrote the famous book 'The Wealth of Nations' in 1776 wherein he defined the importance of specialization in production and brought International trade under the said scope. David Ricardo developed the Comparative advantage principle, which stands true even today.

THEORIES

The main historical theories are called classical and are from the perspective of a country, or country-based. By the mid-twentieth century, the theories began to shift to explain trade from a firm, rather than a country, perspective. These theories are referred to as modern and are firm-based or company-based. Both of these categories, classical and modern, consist of several international theories.

According with Saylor Academy (2012) :

Classical Country-Based Theories	Modern Firm-Based Theories
Mercantilism	Country Similarity
Absolute Advantage	Product Life Cycle
Comparative Advantage	Global strategic Rivalry
Heckscher-Ohlin	Porter's National Competitive Advantage

Classical Country-Based Theories

Mercantilism was an economic system of trade that spanned from the 16th century to the 18th century. Mercantilism is based on the principle that the world's wealth was static, and consequently, many European nations attempted to accumulate the largest possible share of that wealth by maximizing their exports and by limiting their imports via tariffs.

Theories of International Trade

Absolute advantage is the ability of an individual, company, region, or country to produce a greater quantity of a good or service with the same quantity of inputs per unit of time, or to produce the same quantity of a good or service per unit of time using a lesser quantity of inputs, than its competitors.

Comparative advantage is an economy's ability to produce a particular good or service at a lower opportunity cost than its trading partners. A comparative advantage gives a company the ability to sell goods and services at a lower price than its competitors and realize stronger sales margins.

Heckscher-Ohlin is based on a country's production factors—land, labor, and capital, which provide the funds for investment in plants and equipment. They determined that the cost of any factor or resource was a function of supply and demand. Factors that were in great supply relative to demand would be cheaper; factors in great demand relative to supply would be more expensive. Their theory, also called the factor proportions theory, stated that countries would produce and export goods that required resources or factors that were in great supply and, therefore, cheaper production factors. In contrast, countries would import goods that required resources that were in short supply, but higher demand.

Modern or Firm-Based Trade Theories

In contrast to classical, country-based trade theories, the category of modern, firm-based theories emerged after World War II and was developed in large part by business school professors, not economists. The firm-based theories evolved with the growth of the multinational company (MNC). The country-based theories couldn't adequately address the expansion of either MNCs or intraindustry trade, which refers to trade between two countries of goods produced in the same industry.

Country Similarity was developed by Swedish economist Steffan Linder in 1961. He tried to explain the concept of intraindustry trade. He suggested that companies first produce for domestic consumption. When they explore exporting, the companies often find that markets that look similar to their domestic one, in terms of customer preferences, offer the most potential for success. This theory is often most useful in understanding trade in goods where brand names and product reputations are important factors in the buyers' decision-making and purchasing processes.

Theories of International Trade

Product Life Cycle Theory

Raymond Vernon, a Harvard Business School professor, developed the product life cycle theory in the 1960s. The theory, originating in the field of marketing, stated that a product life cycle has three distinct stages: (1) new product, (2) maturing product, and (3) standardized product. The theory assumed that production of the new product will occur completely in the home country of its innovation. In the 1960s this was a useful theory to explain the manufacturing success of the United States.

Global Strategic Rivalry Theory

The global strategic rivalry theory emerged in the 1980s and was based on the work of economists Paul Krugman and Kelvin Lancaster. Their theory focused on MNCs and their efforts to gain a competitive advantage against other global firms in their industry. Firms will encounter global competition in their industries and in order to prosper, they must develop competitive advantages. The critical ways that firms can obtain a sustainable competitive advantage are called the barriers to entry for that industry.

Porter's National Competitive Advantage Theory

Michael Porter of Harvard Business School developed a new model to explain national competitive advantage in 1990. To explain his theory, Porter identified four determinants that he linked together. The four determinants are (1) local market resources and capabilities, (2) local market demand conditions, (3) local suppliers and complementary industries, and (4) local firm characteristics.

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