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## Course Learning Outcomes for Unit III

Upon completion of this unit, students should be able to:

3. Evaluate policies and factors affecting international trade patterns.
4. Distinguish between absolute advantage and comparative advantage trade theories.
5. Explore the influence of regional trading groups on an organization.

## Reading Assignment

In order to access the following resource(s), click the link(s) below:

Burnson, P. (2016). Shape up or ship not. *Logistics Management*, 55(1), 40–43. Retrieved from <https://libraryresources.columbiasouthern.edu/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=112308215&site=ehost-live&scope=site>

Dwyer, R. (2015). TPP to the rescue. *Euromoney*, 46(559), 73–76. Retrieved from <https://libraryresources.columbiasouthern.edu/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=110602247&site=ehost-live&scope=site>

Knowler, G. (2015). The good, bad and ugly of the TPP. *The Journal of Commerce*, 16(22), 36. Retrieved from <https://libraryresources.columbiasouthern.edu/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=110580564&site=ehost-live&scope=site>

Ozgen, E. (2011). Porter's diamond model and opportunity recognition: A cognitive perspective. *Academy of Entrepreneurship Journal*, 17(2), 61–76. Retrieved from <http://link.galegroup.com/apps/doc/A282325730/AONE?u=oran95108&sid=AONE&xid=df8dc084>

Click [here](#) to view the Unit III Presentation. Click [here](#) to access a PDF slide view and transcript of the presentation.

## Unit Lesson

### Searching for a Trade Theory

We all know that some international trade is beneficial. For example, Greenland does not grow bananas, and should it want any, it would have to purchase them from a country that does grow them for export such as Costa Rica or Honduras. The benefits of trade are not limited to tangible goods. International migration and international borrowing and lending are also forms of trade. While nations may gain from international trade, some groups within these nations may be economically hurt. For example, the money spent for bananas in Greenland would not be spent to buy fish from the country's fishermen. The Greenland fishing industry would have less income unless they found an export market, say, to Costa Rica or Honduras.

Since we know that international trade can be beneficial to some constituents and harmful to others, politicians are looking to implement trade policies that benefit their country. Consequently, international economists study the patterns of trade to help explain how trade policies can manipulate the different variables to achieve maximum economic advantage. Multiple theories have emerged to help explain who sells what to whom. Some aspects of trade are easy to understand, such as Greenland buying bananas from Costa Rica. Climate and resource availability clearly explain why certain countries can or cannot produce certain products. Brazil

exports coffee, and Saudi Arabia exports oil. Trade theories also take into account other variables like capital, labor, land, and technical expertise into understanding and predicting trade policies.

### **Classical Theories That Help Explain Why Countries Trade**

**The gravity model:** This is a very simple theory with some credibility. Countries with large economies trade with other countries with large economies. For example, the top four U.S. trade partners are Canada, Mexico, China, and Japan. One reason is that other large economies seek out countries that have trading infrastructure in place and that produce a large variety of products not found in the other countries.

**Country similarity:** This is a theory that compliments the gravity model. Companies create new products in response to market conditions in their home countries. They then turn to markets they see as most similar to what they are accustomed. That may explain why Canada is the largest trading partner of the United States.

**Absolute advantage:** In this theory, some countries produce some goods more efficiently than other countries because of climate and resource availability. Advantages separate into two categories: natural (climate and location) and acquired advantages. We are familiar with natural advantage. Acquired advantage infers that a country has incentivized firms to develop sophisticated technologies that yield valuable products and services. An example would be a country rich in computer technology, such as the United States or India. In either natural or acquired advantage, the bottom line is that a country has achieved the lowest cost to produce a product. Earlier, we mentioned that Saudi Arabia produces oil. Because the Saudis have so much oil, and their oil is easy to get to, their breakeven cost is, at this time, less than \$30 per barrel—lower than almost any other country in the world. The United States is also rich in oil if you include the shale oil formations in the Northwest. However, the U.S. breakeven costs run from around \$50 to \$75 (Tverberg, 2016). Saudi Arabia has the absolute advantage in oil production.

**The Ricardian model (aka the comparative advantage):** This theory works if a country has a lower opportunity cost of producing a product than other countries (Holden, 2008). Each country has limited resources, so if they devote their resources to producing one product, they are foregoing the production of other products. The opportunity cost is what the country gives up when it produces a product. If it is less than what another country gives up to make a product, the first country has a comparative advantage. (Please see the Unit III Presentation for more examples.)

**The Heckscher-Ohlin model (aka the factor proportions theory):** This theory builds on the Ricardian theory by predicting that countries will export products that use their abundant and cheap factors of production and import products that use the countries' scarce factors. The theory emphasizes the interplay between the proportions in which different factors of production are available in different countries and the proportions in which they produce different goods.

**The standard trade model:** While very complex because of supply and demand factors in other countries as well as the host country, a basic explanation is that a country maximizes its well-being if it can sell exports for more money than they cost to produce or buy imports for less than it would cost to produce them. The key process is supply and demand for the products, as well as the factors of production as the price of goods on the world stage is a determinate in the marginal cost (Krugman & Obstfeld, 2008).

### **A Contemporary Theory That Helps Explain How Nations Enhance Competitive Advantage**

**Porter's diamond of national competitive advantage:** While economists look for reasons to explain how international trade works, politicians look for ways to improve economic performance. The diamond theory works on four features as being relevant in determining how to structure your country's trade policy.

- *Demand conditions:* Demand usually starts in the host country and continues to grow into other similar countries.
- *Factor conditions:* The factors of production have to be readily available at affordable prices.
- *Related and supportive industries:* Logistics, transportation, and educational/training facilities must be available and assessable.
- *Firm strategy, structure, and rivalry:* In the beginning, barriers to entry must be low, but as production becomes stable, barriers to entry become high. Usually, there is a high capital requirement followed by a high skill set that is difficult to copy.

Given the plan, a nation can create new advanced factor endowments such as skilled labor, a strong technology and knowledge base, government support, and culture to develop a strong international trading base (Porter, 1990).

### **The Impact of Mobile Production Factors**

The mobility of capital and people affect trade and relative competitive positions. Politicians look for ways to maximize the economic impact of trade. Since production factors also affect trade, politicians also try to control the economic forces that govern the movement of production factors.

**People:** At present rates, 24 countries estimate that they have smaller populations now than they had five years ago. The trend seems to be getting worse with the developed countries. Compare world population growth at 1.18% to the population growth for the United States at .75% or Germany at .06% (United Nations, Department of Economic and Social Affairs, 2015). Lower fertility rates and an aging demographic leave fewer people in the workforce.

GDP relates to a country's output and standard of living. If the output is smaller, the standard of living declines. Many of the world's leaders recognize this problem and are proactive in their positions. U.S. President Obama and German Chancellor Merkel are taking stands to allow large numbers of migrants into their countries. However, while small numbers of migrants easily assimilate into standing populations, large numbers create problems in meeting national values and acceptable levels of education.

Heads of state are quickly learning that migration is good if it is controlled, and assimilation is necessary for a trained and educated labor force to emerge out of the chaos. Given that it takes almost a decade to change a migrant into a productive citizen, it is obvious that the European Union, by accepting millions of migrants from the Middle East, is planning long-term action to replenish their aging and declining workforce.

**Capital:** Long-term capital in the form of foreign direct investment (FDI) and short-term capital in the form of financial transactions and bank loans are the most fluid types of mobile production factors. Investors of both long-term and short-term capital are primarily seeking greater financial returns on their investment than they can get domestically.

Companies invest abroad for the long term to tap markets, improve quality, and achieve lower operating costs. Governments give foreign aid to achieve political and economic goals. Individuals send money to their families still living in foreign countries.

**Technology:** To some extent, capital can replace people with the use of technology. Going further, capital can make people more effective and productive, again with the aid of technology. Technology is the use of specialized knowledge to manipulate production output gains.

In some cases, vendors take their technology to countries to make their factories more productive. In other cases, technology is stolen or copied. For example, China has a colorful history of securing technology by forcing vendors to build their factories in China, by hacking foreign governments, and by buying products for reverse engineering (Carey, 2014). In any case, technology can offset reliance on other production factors by substituting productivity for people and by providing expertise in materials and processes.

### **Government Influence on Trade**

Governments can and often do alter and change trade policies to fit their political goals. Usually, the best trade policies follow the concept of free trade. Free trade is trade without government intervention of imports or exports. However, when the microscope is applied to see how trade is governed, free trade is difficult to achieve. Here are some examples:

**Keeping people employed:** The government of China maintains a full employment policy—despite the cost. The idea is to keep people employed and off the street, thus, keeping them from demonstrating against the government.

**Protecting selective industries:** Some industries like the defense and aeronautics industries have special needs that the government protects. In the United States, defense industry companies have heavy restrictions

against trading on the international markets without approval from the government. Consequently, the industries receive lucrative grants and contracts to make up for those limitations.

**Protecting the environment and national culture:** The recent disapproval of the Keystone XL pipeline was mainly in response to environmental concerns. The prohibition of the sale of ivory is a direct effort to prevent poachers from killing elephants in Africa.

**Responding to other countries:** Many countries may employ a tariff or a quota to restrict outside products from interfering with domestic production. Trade theories recommend that if a country produces a product, they should be the low-cost producer. If the low-cost producer brings that low-cost product into another country, that country's industry cannot compete effectively. The government will sometimes attach a tariff or a quota to that low-cost product making the cost somewhat higher or making it unavailable. In either case, one government takes action, and the reciprocal government takes action—one in response to the other.

**Extending spheres of influence:** Governments in developed countries use trade as part of their foreign aid policy. It is common for the United States to give aid and preferential trade relations to countries that join a political alliance or that vote a preferred way within political bodies. NATO is a direct offshoot of Western Bloc countries forming a trading alliance at the end of World War II.

**Embargoes:** Embargoes and sanctions fall under Article 41 of the United Nations Charter, allowing the Security Council a broad range of enforcement options that do not involve the use of armed force. Since 1966, the Security Council has established 26 sanctions.

### **Global and Regional Trading Organizations**

Governments often cooperate with each other to remove trade barriers. The two ways to look at trading groups are by location (global or regional) or type (such as FTA or OPEC). There are numerous trading groups, and it would be difficult to cover every group in every region, so we will cover just a few of the major groups.

The World Trade Organization (WTO) is the only international organization dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably, and freely as possible. The World Trade Organization came into being in 1995 and has about 160 members, accounting for about 95% of world trade. Around 25 others are negotiating membership (World Trade Organization, 2016).

The North American Free Trade Agreement (NAFTA) is a comprehensive trade agreement that sets the rules of trade and investment between Canada, the United States, and Mexico. Created in 1994, NAFTA has systematically eliminated most tariff and non-tariff barriers to free trade and investment between the three countries (NAFTA, 2012).

The European Union (EU) represents not only economic and trade relations but political ties between 28 European countries. Created in 1958, the EU operates on the rule of law: Everything that it does is founded on treaties, voluntarily and democratically agreed by all member countries (European Union, n.d.).

The Organization of the Petroleum Exporting Countries (OPEC) is a permanent, intergovernmental organization, created in 1960, by Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela. Nine other members later joined the five founding members. OPEC's objective is to coordinate and unify petroleum policies among member countries in order to secure fair and stable prices for petroleum producers. It is worth noting that two of the largest oil producers, the Russian Federation and the United States are not members. (Organization of the Petroleum Exporting Countries, n.d.).

### **Free Trade Agreements**

Free trade agreements (FTAs) have proven to be one of the best ways to open up foreign markets. In the United States, trade agreements reduce export barriers, protect U.S. interests, and enhance the rule of law in participating countries. The reduction of trade barriers and the creation of a more stable and transparent trading and investment environment make it easier and cheaper for U.S. companies to export their products and services to trading partner markets. As of January 1, 2015, the United States has 14 FTAs in force with 20 countries (International Trade Administration, n.d.).

- *Pacific FTA Partners (the TPP)*: The United States is negotiating a regional FTA, the Trans-Pacific Partnership (TPP), with Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam.
- *Atlantic FTA Partners (the T-TIP)*: The United States and the European Union launched negotiations on the Transatlantic Trade and Investment Partnership (T-TIP) in June 2013. (International Trade Administration, n.d.).

## References

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## Suggested Reading

The video below takes a look at absolute advantage and comparative advantage from a different perspective. Please copy and paste the web address into your web browser to navigate to the video and learn more.

- Holden, P. [pajholden]. (2008). *Absolute and comparative advantage* [Video file]. Retrieved from [https://www.youtube.com/watch?v=Pd\\_qs8ueIWw](https://www.youtube.com/watch?v=Pd_qs8ueIWw)