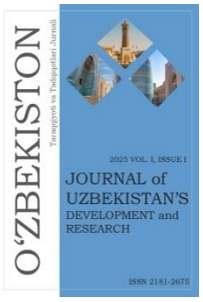

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THEORIES OF INTERNATIONAL TRADE: AN ANALYSIS FROM CLASSICAL TO MODERN APPROACHES

Davronova Charos[1]

University of World Economy and Diplomacy

KEYWORDS

International trade, trade theories, absolute advantage, comparative advantage, Heckscher–Ohlin model, Leontief paradox, new trade theory, strategic trade theory, Porter's competitive advantage, globalization, economic specialization, trade policy.

ABSTRACT

International trade is an integral component of the modern global economic system. The exchange of goods and services between nations contributes to economic growth, specialization, technological advancement, and greater consumer choice. This article is devoted to the theoretical foundations of international trade and analyzes eight key theories that have shaped economic thought throughout history. These theories explore the mechanisms of international trade from various perspectives, covering their historical context, core ideas, and contemporary relevance.

The article begins with classical approaches such as the theory of absolute advantage (Adam Smith) and the theory of comparative advantage (David Ricardo), and extends to modern frameworks including the new trade theory, the strategic trade theory, and Porter's theory of national competitive advantage. Additionally, the Heckscher–Ohlin model, the Leontief paradox, and the product life cycle theory are thoroughly examined.

Each theory is analyzed within its historical context, highlighting its practical applications and significance in today's global economic relations. The aim of the article is to systematically explore the evolution of international trade theories and their influence on global trade policy, as well as to provide students, researchers, and policymakers with a solid theoretical foundation. This study contributes to a deeper understanding of the theoretical underpinnings of international economics.

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International trade and economic relations refer to the movement of goods, services, capital, and intellectual resources across national borders. These interactions are the

[1] Master's student at University of World Economy and Diplomacy

cornerstone of global economic integration and play a vital role in driving national economic development. Through trade, countries can capitalize on specialization, gain access to broader markets, and enhance overall economic efficiency.

Such economic relations also encompass cross-border investments—ranging from multinational corporations establishing subsidiaries abroad to individuals investing in foreign enterprises. To facilitate and safeguard these activities, nations often enter into international trade agreements. These accords aim to lower tariffs, protect investor rights, and establish regulatory frameworks that promote a stable and transparent trading environment.

At its core, international trade is defined as the transnational exchange of goods and services through imports and exports. Imports involve acquiring goods or services from other countries, while exports refer to selling domestically produced items to foreign markets. Over time, economists have developed numerous theories to understand the principles and benefits of global trade. These theoretical models help explain the reasons behind trade flows and the mutual economic gains countries derive from engaging in international commerce.

To grasp the structure and progression of contemporary trade practices, it is essential to explore how international trade functioned in earlier periods. Historically, economists introduced what are now referred to as classical trade theories, which primarily analyze trade from a national or country-based perspective.

The early theoretical frameworks of international trade—such as mercantilism, the theory of absolute advantage, comparative advantage, and the Heckscher-Ohlin model—are considered classical theories, which primarily approach trade analysis from the perspective of entire nations. These models emphasize national-level factors that influence trade flows. However, during the second half of the twentieth century, the focus of trade theory began to shift from countries to individual firms. This transition marked the emergence of modern firm-oriented theories, including the country similarity theory, the product life cycle theory, global strategic rivalry theory, and Porter's theory of national competitive advantage.

Mercantilism

Mercantilism was the mean stream of economics throughout the 16th to the 18th century. Belief in mercantilism began to fade in the late 18th century. The word comes from "mercari", which means "to run a trade"[2].

Under mercantilism, the primary goal of the government in foreign economic policy is to increase the wealth of the nation by acquiring gold. Mercantilists identified national wealth with the size of a nation's reserves of precious metals (which could then be used to hire mercenary armies). Apart from directly mining gold around the world, the primary means for achieving this policy goal was to extract trade gains from foreigners through

[2] Wei-Bin Zhang. (2008). International Trade Theory. Capital, Knowledge, Economic Structure, Money, and Prices over Time, 2008. P.2

regulations and controls so as to achieve a surplus in the balance of trade by increasing exports (e.g., by subsidies) and decreasing imports (e.g., by tariffs and quotas) because trade balances among countries at the time were settled via the transfer of gold[3].

Absolute advantage

One of the earliest and most influential theories of international trade is the theory of absolute advantage, developed by the classical economist Adam Smith in the late 18th century. According to this theory, which laid the foundation for classical trade theories, Adam Smith advocated for unrestricted trade, emphasizing that both exporting and importing nations can benefit from free trade through increased efficiency and specialization. Adam Smith argues that the main benefit from trade is not to increase the total amount of gold and silver stocks of a country, counter to what mercantilist approach claims. If a nation is an efficient producer of a good compared to other nations, then as the most efficient producer, it could expand its market to abroad, hence could be specialized in producing the good in terms of cost and quality. The importer countries, on the other hand, could also receive benefits from this trade due to the fact that it would be much costly for them to produce the same good while a cheaper one provided by the exporter. Therefore, Smith claims that each nation should be specialized on goods they have absolute advantage and should import goods they have absolute disadvantage, consequently the world output could be maximized through using factors of production efficiently and effectively, which in turn increases the wealth of nations[4]. Thus, unlike the mercantilist view that considered trade a zero-sum game—where one nation's gain is another's loss—Adam Smith introduced the idea of trade as a positive-sum game, in which all participating countries can benefit through specialization and efficient resource allocation. This theoretical shift laid the groundwork for explaining how mutual gains from trade are possible, even when one country appears more productive across the board.

Comparative advantage

With absolute advantage comes the dilemma that though some countries may be good at the production of multiple goods thus having advantages in many areas, some other countries in contrast may be deficient in useful absolute advantages. In response to this dilemma, David Ricardo, an English economist, in his book "On the Principles of Political Economy and Taxation", published in 1817, came up with the theory of comparative advantage. Ricardo reasoned that even if Country A had the absolute advantage in the production of all products, specialization and trade could still occur between two countries. Comparative advantage is said to occur when though a country produces a product less efficiently than another country; it has the ability to produce that product better and more efficiently than it does other goods. In other words, relative efficiency is the most important thing in this context. Whereas absolute advantage is concerned with

[3] Oded Shenkar, Yadong Luo and Tailan Chi. International Business, 2022, 4th edition. P.31

[4] Levent Vurgun, Furkan Metin. Evaluation of the Adequacy of the Trade Theories' Assumptions to Explain the Impact of NICs/Regions on International Trade. 2013

absolute productivity, the relative productivity difference is the major focus of comparative advantage[5].

Heckscher-Ohlin Factor Endowment Theory

Eli Heckscher and his student, Bertil Ohlin, added a complexity to Ricardo's theory, and this rationale explained why comparative advantage occurs. Through their work Heckscher and Ohlin found that advantages resulted from "factor endowments," such as land, labor and capital[6].

It is worth to note that the difference between the Ricardian and Heckscher-Ohlin model is the former postulates differences in production technologies between countries, while the latter assumes that production technologies are the same. Also, the Heckscher-Ohlin model assumes there are no differences in the aggregate preferences between countries. The only difference existing is that different countries have different resource endowments, and this major discrepancy is sufficient to cause a different production possibility frontier in the two countries such that equilibrium price ratios would differ in an autarky.

The six assumptions in the Heckscher-Olin theory:

i) No transport costs or trade barriers (meaning that commodity prices are the same in all countries within the purview of a free trade regime).

ii) Perfect competition in factor and commodity markets.

iii) A homogeneous production function, which signifies constant returns to scale.

iv) Given the production functions, two goods always display contrasting factor intensity levels.

v) Production functions differ among goods, but are similar in both countries.

vi) Tastes are similar in both countries[7].

Leontief Paradox

In the early 1950s, Russian-born American economist Wassily W. Leontief studied the US economy closely and noted that the United States was abundant in capital and, therefore, should export more capital-intensive goods. However, his research using actual data showed the opposite: the United States was importing more capital-intensive goods. According to the factor proportions theory, the United States should have been importing labor-intensive goods, but instead it was actually exporting them. His analysis became known as the Leontief Paradox because it was the reverse of what was expected by the factor proportions theory. In subsequent years, economists have noted historically at that point in time, labor in the United States was both available in steady supply and more productive than in many other countries; hence it made sense to export labor-intensive goods. Over the decades, many economists have used theories and data to explain and

[5] Chike A. Ezenwa, J.I. Iheanacho, H.I. Okafor (2021). Theories of International Trade

[6] George L. De Feis, Donald Grunewald, and George N. De Feis (2016). International Trade Theory of Hyper-Globalization and Hyper-Information Flow Conceived. International Journal of Business & Applied Sciences. Vol. 5(1), pp.23-29.

[7] Tri-Dung Lam (2015). A Review of Modern International Trade Theories. American Journal of Economics, Finance and Management. Vol 1(6), pp 604-614.

minimize the impact of the paradox. However, what remains clear is that international trade is complex and is impacted by numerous and often-changing factors. Trade cannot be explained neatly by one single theory, and more importantly, our understanding of international trade theories continues to evolve[8].

Country Similarity Theory

The Country Similarity Theory was introduced by Swedish economist Steffan Linder in 1961 in his publication *"An Essay on Trade and Transformation."* In this work, Linder sought to explain intra-industry trade by focusing on the structure of consumer demand. He proposed that a manufactured product is typically not exported until there is a solid demand for it within its country of origin. This is due to the fact that production is initially intended to satisfy local market needs. Only after a product gains popularity domestically does it begin to be traded internationally. The theory further suggests that countries with comparable income levels tend to exhibit similar demand structures, leading them to engage in trade with one another more frequently. As such, this theory is particularly relevant for analyzing trade in goods where brand image and product reputation heavily influence consumer preferences and purchase decisions. Nevertheless, Linder's theory is not without limitations. It does not adequately clarify why a country would prioritize developing a domestic market for a product that is ultimately meant for export. Additionally, the theory falls short in addressing the role of product quality in international trade dynamics.

Product Life-Cycle Theory

The Product Life-Cycle Theory was introduced by American economist Raymond Vernon in 1966 in his influential work *"International Investment and International Trade in the Product Cycle."* This theory provides an explanation of international trade patterns by focusing on the evolution of products through various stages of their life cycles. Unlike classical theories that primarily emphasized comparative advantage and factor endowments, Vernon's model integrates technological innovation and market development into the trade process.

According to Vernon, new products are typically developed and first consumed in developed countries due to higher income levels, advanced technology, and sophisticated consumer preferences. As the product gains acceptance in the domestic market, it begins to be exported to other developed nations. Eventually, as the product matures and becomes standardized, production shifts to developing countries where labor costs are lower, enabling more cost-effective manufacturing. In this phase, the original innovating country may even become an importer of the product it once exported.

The theory divides the product's journey into four main stages:

1. Introduction Stage: The product is invented and produced domestically in the innovating country (typically a developed economy). The production is small-scale and

[8] Saylor Academy. (n.d.). *What is international trade theory?* https://saylordotorg.github.io/text_international-business/s06-01-what-is-international-trade-th.html

serves local demand.
2. Growth Stage: Demand increases, and the product is exported to other developed markets. Firms may establish foreign production facilities to meet rising international demand.
3. Maturity Stage: The product becomes widely accepted and standardized. Production shifts to developing countries to take advantage of lower labor costs and economies of scale.
4. Decline Stage: The product faces competition from newer innovations. The innovating country reduces production or stops it altogether, while developing countries continue producing for global or regional markets.

This theory provides valuable insight into how trade and foreign direct investment evolve over time, highlighting the dynamic nature of international trade flows and the relocation of production across borders. It is particularly relevant to technology-intensive and manufactured goods, such as electronics, appliances, and automobiles.

Strengths of the Theory:

- Explains the role of innovation and technology in trade.
- Highlights how comparative advantage shifts over time.
- Connects foreign direct investment with product evolution.

Criticisms:

- Less applicable in today's highly globalized markets where products are often launched globally.
- Assumes a linear progression which may not reflect real-world complexity.
- Does not fully account for the speed of modern technological diffusion and global supply chains.

Porter's Diamond Model (Theory of National Competitive Advantage)

Porter's Diamond Model was developed by Michael E. Porter, a renowned Harvard Business School professor, in his seminal book *"The Competitive Advantage of Nations"* published in 1990. This theory aimed to explain why certain nations and industries within those nations are more competitive internationally than others. Unlike earlier international trade theories that focused on factor endowments or economies of scale, Porter's model takes a broader and more dynamic approach to competitiveness.

According to Porter, four interrelated factors form a "diamond" that determines a country's national competitive advantage:

1. Factor Conditions: These refer to a nation's position in terms of production factors, such as skilled labor, infrastructure, capital, and natural resources. Porter emphasized that specialized and advanced factors (e.g., research institutions, technical education) are more important than general resources in building competitiveness.
2. Demand Conditions: The nature and sophistication of domestic market demand influence how firms innovate and improve. Strong local demand pressures companies to meet high standards, which in turn prepares them for international competition.
3. Related and Supporting Industries: The presence of competitive supplier industries

and related sectors within a nation enhances efficiency and innovation. Clusters of interconnected firms encourage synergy, knowledge spillovers, and faster product development.

4. Firm Strategy, Structure, and Rivalry: The way companies are created, organized, and managed—along with the intensity of domestic rivalry—shapes the business environment. Intense domestic competition drives firms to become more efficient, innovative, and internationally competitive.

Additionally, Porter included two external variables that influence the diamond:

- Government: Through regulation, subsidies, education policy, and infrastructure development, governments can influence all four main factors.
- Chance: Events beyond the control of firms or governments (e.g., wars, pandemics, technological breakthroughs) can reshape industry dynamics and national advantages.

Conclusion

Porter's Diamond Model offers a comprehensive framework for understanding the sources of national competitive advantage in international trade. Unlike classical theories that emphasize natural endowments or cost advantages, Porter's model highlights the dynamic and interactive nature of competitiveness, shaped by domestic demand, factor conditions, related industries, and firm rivalry. It underscores the importance of innovation, strategic management, and the role of government in fostering favorable conditions for international success.

Although the model has limitations—particularly in the context of globalization and its applicability to developing countries—it remains a valuable tool for analyzing why certain nations outperform others in specific industries. For policymakers, it provides guidance on how to develop competitive sectors, while for firms, it reveals the underlying conditions that drive productivity and global positioning.

In conclusion, Porter's Diamond Model expands the understanding of international trade by integrating economic, institutional, and strategic dimensions, making it highly relevant in today's interconnected global economy.

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