

Globalization Wave Globalization 1.0 (1800-1914) Globalization 2.0 (1945-1989) Globalization 3.0 (1989-2008) Globalization 4.0 (2009-)

Learning Objectives

- To understand theories of why and how countries trade
- To become familiar with factors affecting countries' trade patterns
- To discern why the production factors of labor and capital move internationally
- To grasp the relationship between foreign trade and industry competitiveness

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Gout.

↓

Interventionist Theories

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Interventionist Theories

- It prescribes government action with respect to the international trade process

- 1 • Mercantilism
 - dominant in Europe from the 16th to the 18th centuries
 - a country's wealth is measured by its holdings of treasure (usually gold)
- 2 • Neo mercantilism
 - in vogue currently
 - use favorable trade position for social and political advantage

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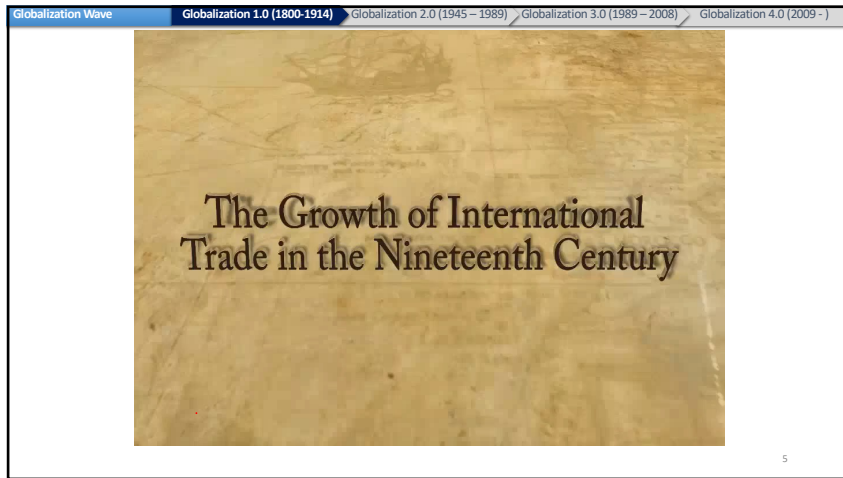
Interventionist Theories

- **Mercantilism**
 - Maximize the trade of a nation with the aim to maximize the accumulation of gold and silver
 - Mercantilists viewed the economic system as a zero-sum game
 - To amass a surplus, a country must export more than it imports and then collect gold and other forms of wealth from countries that run trade deficits
 - Government intervenes to achieve a surplus in exports
 - King, exporters, domestic producers: happy
 - Subjects: unhappy because domestic goods stay expensive and of limited variety

Trade Surplus.
 ↳ Exports ↑
 ↳ Imports ↓
 win lose

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Interventionist Theories

- Outcome
 - Wars
 - Colonialism
 - First industrial revolution
 - American war of Independence
 - First Indian war of Independence

Tea - China -> Darjeeling -> USA

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Interventionist Theories

- **Neo Mercantilism**
 - The objective of neo-mercantilist policies is to increase the level of foreign reserves held by the government, allowing more effective monetary policy and fiscal policy.
 - **Undervaluation of currency:** keep exchange rate undervalued and make exports more competitive
 - **Subsidy & Tariff on imports:** Government subsidy for industry e.g. steel in China
 - **Social advantage:** to have full employment of resources in order to have surplus production that can be exported
 - **Political advantage:** to give aid and grant to other countries

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Interventionist Theories

- Justification for **Neo Mercantilism**
 - **Tariffs in response to domestic subsidies:** China's steel is effectively subsidized leading to a glut in supply. Hence it is necessary to impose tariffs on imports of Chinese steel to protect domestic producers from unfair competition.
 - **Protection against dumping:** If some countries have excess supply of goods, they can sell at a very low price to get rid of the surplus. Protectionism can be justified to protect against this dumping
 - **Infant industry:** For countries seeking to diversify their economy, tariffs may be justified to try and develop new industries.

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↗ ↗ implementation

Free Trade Theories

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Free Trade Theories

- Free trade is a policy that recommends specialization of production and free flow of goods benefiting all trading partners' economies
 - Free trade (a positive-sum game) implies *specialization* and requires that nations neither artificially limit imports nor artificially promote exports
 - The invisible hand of the market determines which competitors survive, as customers buy those products that best serve their needs
- Absolute Advantage (Adam Smith, 1776)
- Comparative Advantage (David Ricardo, 1817)

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Free Trade Theories

- **Absolute advantage**
 - Maximize own economic well being by specializing in the production of goods and services that it produces more efficiently than other nations
 - Enhance global efficiency through its participation in free trade.
 - workers become more skilled by repeating the same tasks
 - workers do not lose time in switching from the production of one kind of product to another
 - longer production runs provide greater incentives for the development of more effective working methods

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How does the Theory of Absolute Advantage Work?

Resources Required to Produce 1 Ton of Cocoa and Rice		
	Cocoa	Rice
→ Ghana	10	20
→ South Korea	40	10

given.

Production and Consumption without Trade		
Ghana	100	5.0
South Korea	2.5	10.0
Total production	100	15.0

200 units. 100/10 = 100 tons 100/20 = 5.0

Production with Specialization		
Ghana	200	0.0
South Korea	0.0	20.0
Total production	200	20.0

200 units. 200 tons

Consumption after Ghana Trades 6 Tons of Cocoa for 6 Tons of South Korean Rice		
Ghana	14.0	6.0
South Korea	6.0	14.0

1 cocoa = 1 Rice.

Increase in Consumption as a Result of Specialization and Trade		
Ghana	4.0	1.0
South Korea	3.5	4.0

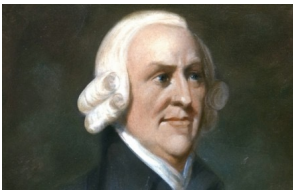
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Free Trade Theories

- **Absolute advantage**
 - Export those goods and services for which a country is more productive than other countries
 - Country should concentrate on production of goods in which it holds an absolute advantage
 - Import those goods and services for which other countries are more productive
 - Measures nations wealth by the standard of living of its citizens, rather than their gold reserves
- Adam Smith: *The Wealth of Nations*, 1776



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Free Trade Theories

- **Comparative advantage**
 - Maximize own economic well-being by specializing in the production of those goods and services it can produce relatively efficiently and
 - a country can simultaneously have an absolute and a comparative advantage in the production of a given product
 - Absolute Advantage is a special case of Comparative Advantage
 - Enhance global efficiency via participation in free trade.
 - by concentrating on the production of the product in which it has the greater advantage, a country can further enhance both global output and its own economic well-being

Opportunity Cost.

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Free Trade Theories

- **Comparative advantage**
 - David Ricardo asked what happens when one country has an absolute advantage in the production of all goods
 - The theory of comparative advantage (1817)—countries should specialize in the production of those goods they produce most efficiently and buy goods that they produce less efficiently from other countries
 - even if this means buying goods from other countries that they could produce more efficiently at home

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Resources Required to Produce 1 Ton of Cocoa and Rice

	Cocoa	Rice
Ghana	10	13.33
South Korea	40	20

Handwritten: ✓, 10 units, 13.33, 40, 20

Production and Consumption without Trade

Ghana	10.0 tons	7.5 tons
South Korea	2.5 tons	5.0 tons
Total production	12.5	12.5

Handwritten: 200, 100, 100, 100, 200, 12.5, 12.5

Production with Specialization

Ghana	150	3.75
South Korea	0	10.0
Total production	150	13.75

Handwritten: 150, 50, 0, 200

Consumption after Ghana Trades 4 Tons of Cocoa for 4 Tons of South Korean Rice

Ghana	4 tons Cocoa	4 tons Rice	7.75
South Korea	4.0	6.0	6.0

Handwritten: 15-4, 3.75+4, 4 tons Cocoa, 4 tons Rice, = 11.0, = 7.75

Increase in Consumption as a Result of Specialization and Trade

Ghana	1.0	0.25
South Korea	1.5	1.0

How does the Theory of Comparative Advantage Work?

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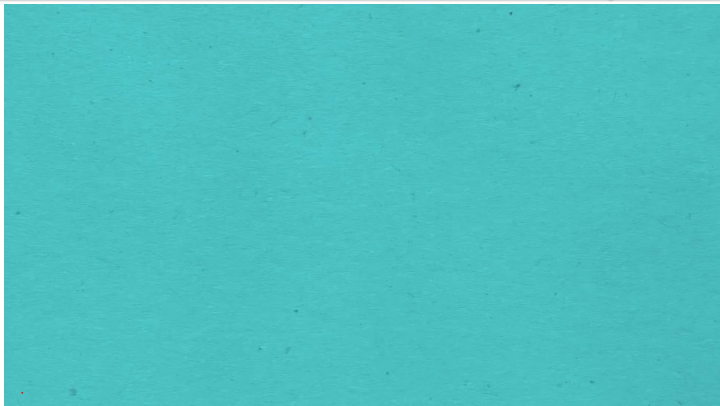
Free Trade Theories

- **Comparative advantage**
 - Extends free trade argument
 - Efficiency of resource utilization leads to more productivity
 - Should import even if country is more efficient in the product's production than country from which it is buying
 - Look at **opportunity cost**
- David Ricardo: *Principles of Political Economy*, 1817



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Free Trade Theories (Revised)

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Free Trade Theories (Revised)

- These theories explain the patterns of international trade taking into account Country Size, Factor Proportions, Country Characteristics
 - what types of products are traded
 - with which partner nations countries will primarily trade
- Factor proportions theory (HO)
 - A mathematical model of international trade, developed by Eli Heckscher and Bertil Ohlin at the Stockholm School of Economics
- Product life cycle theory (PLC)
 - Developed in response to failure of Heckscher-Ohlin model to explain the observed pattern of international trade.
 - Ray Vernon, 1966

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Free Trade Theories (Revised)

- **Heckscher–Ohlin model (H–O model)** *model.*
 - It builds on David Ricardo's theory of comparative advantage by predicting patterns of commerce and production based on the factor endowments of a trading region
- Differences in a country's relative endowments of land, labor, and capital explain differences in the cost of production factors.
 - The model essentially says that countries will export products that use their abundant and cheap factor(s) of production and import products that use the countries' scarce factor(s).
 - The composition of a country's trade depends on both its natural and acquired advantages. With respect to the latter, both production and product technology can be very important.

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Free Trade Theories (Revised)

- **Heckscher–Ohlin model (H–O model)**
 - The model says that countries will export products that use their abundant and cheap factor(s) of production and import products that use the countries' scarce factor(s).
- The composition of a country's trade depends on both its natural and acquired advantages.
 - Acquired advantage include both production and product technology.

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Free Trade Theories (Revised)


- **Heckscher–Ohlin model (H–O model)**
 - Differences in factor endowments, and not on differences in productivity determine patterns of trade
 - Absolute amounts of factor endowments matter
- Leontief paradox:
 - US has relatively more abundant capital yet imports goods more capital intensive than those it exports
- Explanation(?) *Check later*
 - US has special advantage on producing new products made with innovative technologies *Scarce*
 - These may be less capital intensive till they reach mass-production state

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Free Trade Theories (Revised)

- **Product life cycle theory (PLC)** 
 - The optimal location for the production of certain types of goods and services shifts over time as they pass through the stages of: (i) introduction, (ii) growth, (iii) maturity, and (iv) decline.
 - During the decline stage, a product is often imported by the country where it was initially developed; however, the importing firm may or may not be the innovating firm
 - The **product life-cycle theory** - as products mature both the location of sales and the optimal production location will change affecting the flow and direction of trade
 - proposed by Ray Vernon in the mid-1960s

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Free Trade Theories (Revised)

- **Product life cycle theory (PLC)**
 - Most new products conceived / produced in the developed countries
 - Exports more attractive than overseas production

A line graph titled 'A. United States' with a y-axis from 0 to 160. It shows three curves: 'Production' (green), 'Exports' (purple), and 'Consumption' (blue). Production starts at 0, rises to a peak of about 100, and then declines. Exports start at 0, rise to a peak of about 100, and then decline. Consumption starts at 0, rises to a peak of about 100, and then declines. A red circle highlights the initial rise of the Production curve.

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Free Trade Theories (Revised)

- **Product life cycle theory (PLC)**
 - Limited initial demand in other advanced countries initially
 - When demand increases in advanced countries, production follows

A line graph titled 'B. Other Advanced Countries' with a y-axis from 0 to 160. It shows three curves: 'Consumption' (blue), 'Imports' (purple), and 'Production' (green). Consumption starts at 0 and rises steadily. Imports start at 0 and rise to a peak of about 100. Production starts at 0 and rises to a peak of about 100. A red circle highlights the initial rise of the Imports curve.

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Free Trade Theories (Revised)

- **Product life cycle theory (PLC)**
 - With demand expansion in secondary markets, product becomes standardized
 - production moves to low production cost areas
 - Product now imported to US and to advanced countries

A line graph titled 'C. Developing Countries' with a y-axis from 0 to 160. It shows three curves: 'Consumption' (blue), 'Imports' (purple), and 'Production' (green). Consumption starts at 0 and rises steadily. Imports start at 0 and rise to a peak of about 100. Production starts at 0 and rises to a peak of about 100. A red circle highlights the initial rise of the Imports curve. The x-axis is labeled 'Stages of Product Development' with three stages: 'New Product', 'Maturing Product', and 'Standardized Product'.

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Free Trade Theories (Revised)

- **Product life cycle theory (PLC)**

Stage	Introduction	Growth	Maturity	Decline
Production Location(s)	Innovating country	Innovating + Other Industrial countries	Industrial countries + Developing countries	Developing countries
Market Location(s)	Innovating + Other Industrial countries	Other Industrial countries	Other Industrial countries + Developing countries	Developing countries
Competitive Factors	Uniqueness	Rising competition & demand	Price competition	Declining demand
Production Technology	Short production runs	Capital input increases	Economies of scale	Rationalization

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Free Trade Theories (Revised)

- Exceptions to the typical pattern of the PLC would include:
 - products that have very short life cycles *fashion*
 - luxury goods and services
 - products that require specialized labor *watches.*
 - products that are differentiated from competitive offerings
 - products for which transportation costs are relatively high

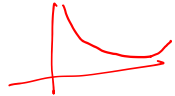
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Challenges to Free Trade

- Assumptions
 - Simple world – 2 countries & 2 goods
 - Transportation cost?
 - Exchange rate?
 - Change in production of goods, frictionless?
 - Constant returns to scale?
 - Efficiency is linear?
 - Effect of trade on income distribution?



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Challenges to Free Trade

- 1930s. Edward Chamberlin & Joan Robinson developed **theory of imperfect competition**,
 - undermining the notion that market prices reflect social costs & questioning free trade
- 1950s – 1960s heyday of free trade with successive GATT rounds;
 - trade mostly expanded in developed countries, whereas many developing countries embraced “infant industry” & “import substitution” arguments
- “**Market failure**” argument was used to justify intervention
 - led to theory of optimal policy intervention – which showed trade policy was 2nd best intervention, with domestic policy 1st best

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New Trade Theory

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New Trade Theory

- In late 1980s, Helpman/Krugman coined the imperfectly competitive framework as the “**new trade theory**”
- Theorists noted that much trade is dominated by a small number of large firms & this raised the following question:
 - could increasing returns cause trade? (as opposed to exogenous differences in technology or factor endowments)
- They also noted that trade in differentiated products is more important than homogeneous goods trade.
 - Theorists argued that increasing returns (which typically leads to imperfect competition) could be as fundamental a cause of international trade as comparative advantage.

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Competitive Advantage

- The nature of competition and sources of competitive advantage **differ widely among industries.**
- Firms gain and sustain competitive advantage in modern international competition **through innovation.**
- Firms that successfully gain competitive advantage in an industry are those that **move early and aggressively to exploit a new market or technology.**

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Competitive Advantage *Porter Diamond Model*

The diagram illustrates the Porter Diamond Model with the following components and relationships:

- Government Policies** (top left) has a bidirectional arrow to **Firm Strategy, Structure, and Rivalry** (top center).
- Firm Strategy, Structure, and Rivalry** (top center) has bidirectional arrows to **Factor Endowments** (middle left), **Demand Conditions** (middle right), and **Related and Supporting Industries** (bottom center).
- Factor Endowments** (middle left) has bidirectional arrows to **Related and Supporting Industries** (bottom center) and **Demand Conditions** (middle right).
- Demand Conditions** (middle right) has bidirectional arrows to **Related and Supporting Industries** (bottom center) and **Chance** (bottom right).
- Chance** (bottom right) is an external factor.

Handwritten notes: "Land Labor Capital" with an arrow pointing to "Factor Endowments"; "Porter Diamond Model" in red text.

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Implication of trade theories

1. **Location implications** - a firm should disperse its various productive activities to those countries where they can be performed most efficiently
 - firms that do not may be at a competitive disadvantage
2. **First-mover implications** - a first-mover advantage can help a firm dominate global trade in that product
3. **Policy implications** - firms should work to encourage governmental policies that support free trade
 - want policies that have a favorable impact on each component of the diamond

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What is Global today?

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“The world is flat.”
-THOMAS L. FRIEDMAN

Friedman argued:

- Globalization and information technology have diminished the importance of location
- World has become a unified playing field for companies and individuals competing with each other

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It's a Flat World, After All

- Globalization 1.0 (1800 to 1914)
 - Dynamic force was countries globalizing for resources and imperial conquest
- Globalization 2.0 (1945 to 1989)
 - Dynamic force was companies globalizing for markets and labor
- Globalization 3.0 (1989 to 2008)
 - Dynamic force is individuals and small groups globalizing
- Globalization 4.0 (2009 to)

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It's a Flat World, After All

1. Berlin wall is broken (Nov 9, 1989) *USSR.*
 - allowed us to think of the world as a single space
2. Netscape went public (Aug 9, 1995) *IT*
 - Display images and data in browser
 - Start of dot-com boom
 - Overinvestment in IT infra
3. Workflow standardization
 - Application to application connectivity

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It's a Flat World, After All

4. Outsourcing
5. Offshoring
6. Open-sourcing
7. In-sourcing
8. Supply-chaining
9. Informing

↓

10. The steroids (wireless access & VoIP)

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WHAT IS GLOBAL?

Regional and country specific differences are very induring.

Alan Rugman

- Challenged traditional assumptions of globalization
- Emphasized the importance of regions

EU

NAFTA

SAARC

Pankaj Ghemawat

- Created the phrase "semiglobalization"
- Argues that cultural, administrative, geographic and economic differences are far more enduring than often assumed

CAGE


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Flat World vs Round World

- Internet eliminated geographic barriers
- Traditionally local businesses are now able to reach a global audience
- The flat world is a world with free access to markets, few barriers to competition, and consistent enforcement of regulations
- Round world argument—insists that the world is not as connected as we might think



"The presumption that ten percent of activity is conducted globally, with ninety percent being domestic"

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Why the World Isn't Flat

- The 10 per cent presumption
 - FDI accounts for less than 10% of the world's capital formation
 - Since the 2008 financial crisis, international trade in merchandise has increased, but trade in service has been stagnant
 - Financial markets are becoming less globalized as investors keep more of their funds in their home markets
- A strong national defence
 - Boundaries matter
 - Distance matters

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Why the World isn't Flat

- *Developed countries* such as the United States and Europe have turned strongly against globalization, in favour of nationalization
- *Emerging Markets*- countries moving toward economic policies of open trade and free markets
 - Emerging market economies have driven most of the recent growth in globalisation

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“The world is spiky.”

-RICHARD L. FLORIDA

Richard L. Florida:

- Opposing view to Friedman
- Importance of industry clusters
- Emphasizes the emergence of mega-cities that offer significant competitive advantages

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WHAT IS GLOBAL?

Today, we have to recognize that the enlightenment optimism with free trade, open borders and liberalism is gone:

- China is seen by many as the culprit that led to the structural reshaping of globalization
- US steps towards isolationism: withdrawing from trade treaties, multilateralism and global commitments
- The Covid-19 crisis with associated border closures and travel bans unearthed an extreme form of national interest first attitude.

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WHAT IS GLOBAL?

- Micro-Multinational Corporations- small, web-wired start-ups that are using social media to recruit the best talent from around the world and leverage it for immediate innovation and impact
 - Lower staffing cost
 - Greater access to talent and expertise
 - Wider choice of markets than they might find at home
 - Capitalise on speed and agility
 - Maintain communication and coordination across borders
- With globalization and the ease of becoming a multinational, the U.S and other developed countries no longer dominate the global market

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Theories to understand the current context

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Unified Framework for Global Business

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First Core Perspective: An Institution-based View

- An institution-based view suggests that the success and failure of firms are enabled and constrained by institutions (the rules of the game)

Edus health legal.

A Typology of Emerging Economies

Institutional Development	Strong	Mid-Range Emerging Economies (e.g., INDIA)	Newly Developed Economies (e.g., SOUTH KOREA)
	Weak	Traditional Emerging Economies (e.g., BELARUS)	Mid-Range Emerging Economies (e.g., BRAZIL, RUSSIA)
		Less	More
		Infrastructure and Factor Market Development	

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Second Core Perspective: A Resource-based View

- A resource-based view focuses on a firm's internal resources and capabilities
- liability of foreignness** – the inherent disadvantage that foreign firms experience in host countries because of their nonnative status

made in china

Multinationals Possess Better Management Capabilities Than Do Local Firms

Source: Adapted from N. Bloom, C. Genakos, R. Sadun, & J. Van Reenen, 2012, Management practices across firms and countries (p. 23), *Academy of Management Perspectives*, February: 12–33. Sample of 7,262 manufacturing and 661 retail firms, of which 5,441 are purely domestic and 2,482 are foreign multinationals. Domestic multinationals (such as the domestic subsidiaries of Toyota in Japan) are excluded.

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Once more...

Interventionist Theories	Free Trade Theories	Free Trade Theories (Revised)	New trade theory	Current IB Research
Mercantilism	Absolute advantage	Factors proportion theory (Heckscher–Ohlin model)	Comparative advantage	Institution Based View
Neo-mercantilism	Comparative advantage	PLC theory		Resource Based View

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