

Module: International Business Management
Class: 1st Year Master Business Management

LECTURE THREE:
THEORIES OF TRADE,
FOREIGN DIRECT INVESTMENT,
INTERNATIONALIZATION

Dr. Kamilia Izzrech
Department of Management
University Mohamed Khider-Biskra

Academic year 2025/2026/ semester 1

Contents of lecture:

Introduction

- 1- Definition of international trade
- 2- International trade theories: Classical and Modern
- 3- Implications of theories in international business

Summary and questions:



Introduction



International trade theories consist of economic frameworks *designed to explain global trade dynamics*—specifically, which goods are exchanged between countries and who participates in these exchanges.

These models help us understand the broader impact of globalization, shedding light on its advantages and disadvantages for entire economies as well as specific social or economic groups.

At the heart of **modern trade theory** lies *David Ricardo's* principle of **Comparative Advantage**. This enduring idea suggests that even if one country is more efficient at producing all goods, it can still benefit from trading with another country. The key insight is that trade becomes mutually beneficial when countries specialize based on **relative opportunity costs**, not just **absolute efficiency**. Multiple theories of international trade explain why countries trade and how they benefit from it.

These theories have evolved over time, moving from country-level to firm-level explanations and incorporating factors like technology, economies of scale, and consumer demand.

1- Definition of International Trade



Definition of International Trade

- **Trade** is the concept of exchanging goods and services between two people or entities.
- **International trade** refers to the exchange of goods and services **across national borders**. It involves **imports** (goods or services brought into a country) and **exports** (goods or services sold to another country). This exchange allows countries to access products they may not produce efficiently or abundantly themselves.
- **key aspects of international trade:**
 - **Imports and Exports:** The core of international trade—imports flow into a country, exports flow out.
 - **Economic Linkage:** It creates connections between economies, fostering interdependence and cooperation.
 - **Global Reach:** Enables producers to expand markets beyond domestic boundaries, often leading to innovation and improved quality.
 - **Risks and Regulations:** Includes challenges like exchange rate fluctuations, trade policies, and legal systems

Why international trade?

- International trade can be a shift for many nations, from unproductive to productive economy. From no *comparative advantage* to more productive uses of some resources.
- Many economic policies *encourage* international trade but they may have not positive results (example of Ghana and South Korea).
- Thus, it is important to review theories that explain why it is beneficial for a country to engage in international trade.
- Furthermore, it is essential to explain the *pattern* of exports and imports of products between countries.



Meaning of **Patterns** of World Trade

- Patterns of world trade *refer to the distribution* of exports and imports among countries. The patterns of world trade are influenced by factors such as the level of economic development, natural resources, political factors, and technological advancements. The patterns of world trade can be analyzed using indicators such as the trade balance, export intensity, and import intensity.

■ History of Patterns of World Trade

The history of patterns of world trade can be traced back to **the ancient Silk Road trade routes**, which connected China to Europe and the Middle East. **The Silk Road facilitated the exchange of goods such as silk, spices, and precious metals.** **During the colonial era, European powers established trade routes with their colonies in Africa, Asia, and the Americas,** leading to the transfer of goods such as **sugar, tobacco, and cotton.**

In the 20th century, the rise of globalization and the growth of international organizations such as the World Trade Organization (WTO) have facilitated the growth of world trade.

- **Types of Patterns of World Trade:** The patterns of world trade can be classified into three main types: intra-industry trade, inter-industry trade, and resource-based trade.
 - **Intra-Industry Trade:** This refers to the exchange of **similar** goods between countries. Intra-industry trade is common among **developed** countries that produce similar goods, such as automobiles or electronics.
 - **Inter-Industry Trade:** This refers to the exchange of **dissimilar** goods between countries. Inter-industry trade is common between **developed and developing** countries, where the developed country exports manufactured goods, and the developing country exports raw materials.
 - **Resource-Based Trade:** This refers to **the exchange of natural resources** between countries. Resource-based trade is common among **developing** countries that export raw materials, such as oil or minerals, to **developed** countries.

Ghana: Cocoa-Rich but Structurally Constrained	South Korea: No Cocoa, but Strategic Trade Success
<ul style="list-style-type: none"> • Export Profile: Ghana is one of the world's top cocoa producers. In 2023, it exported about \$7.98 million worth of cocoa and cocoa preparations to South Korea, mostly in raw or semi-processed forms like cocoa beans and paste. • Command Economy Legacy: In the 1970s, Ghana adopted a command economy. The cocoa sector was nationalized, forcing farmers to sell to the government at below-market prices, while buying tools at inflated rates. • Impact on Farmers: <ul style="list-style-type: none"> • Loss of incentive to improve quality or increase production. • Decline in cocoa quality due to underinvestment in farming infrastructure. • Trade Limitation: Ghana's reliance on raw exports and limited value-added processing has constrained its ability to benefit fully from global trade. 	<ul style="list-style-type: none"> • No Cocoa Production: South Korea does not produce cocoa, but it imports it for its thriving food and cosmetics industries. • Free Market Strategy: Unlike Ghana, South Korea embraced export-led industrialization and free trade policies, investing in manufacturing and technology. • Value Addition: Korea imports raw cocoa and transforms it into high-value products (e.g., chocolate, cosmetics), then exports those globally. • Trade Outcome: Korea's strategic use of imports for industrial transformation has led to massive economic growth, despite having no natural cocoa resources.

Key Lessons from the Cocoa Case		
Factor	Ghana	South Korea
Cocoa Production	Major producer	None
Trade Strategy	Export raw cocoa	Import cocoa, export value-added goods
Economic Model	Command economy (1970s)	Free market, export-led growth
Farmer Incentives	Suppressed by state pricing	Not applicable
Industrial Transformation	Limited	Extensive
Outcome	Stagnation in cocoa sector	Growth via strategic trade and innovation

2- International Trade Theories



● An overview of Trade Theory

Propagated in the 16th and 17th centuries., **mercantilism** advocated that countries should simultaneously encourage exports and imports.

Although mercantilism is an old largely discredited doctrine, its echoes remain in the modern political debate and in the trade policies of many countries.

- **Adam Smith's** theory of **absolute advantage**, 1776, was the first to explain why unrestricted free trade is beneficial to a country.

Free trade occurs when a government does not attempt to influence through quotas or duties what its citizens can buy from another country or what they can produce and sell to another country.

Smith's theory emphasized the importance of the **invisible hand**, rather than government policy, in determining the country's imports and exports.

- **David Ricardo's** theory of **comparative advantage**, 19th century, is the intellectual basis of modern argument for unrestricted free trade.
- Heckscher-Ohlin theory, 20th century, Ricardo's work refined.

Classical theories in international trade

(Country based)

Mercantilism (16th–18th century): This early theory viewed international trade as a **zero-sum game**, where national wealth was measured by gold and silver reserves. It advocated for **maximizing exports and minimizing imports** through protectionism. Adam Smith later criticized this approach, arguing that trade could be a positive-sum game.

Absolute advantage (Adam Smith, 1776): Smith proposed that countries should **specialize** in and export goods they produce more efficiently than others, leading to increased global efficiency and output through free trade. This theory didn't fully explain trade when one country was more efficient in producing all goods.

Comparative advantage (David Ricardo, 1817): Ricardo built on Smith's work, arguing that **mutually beneficial trade** is possible even if one country has an absolute advantage in everything. The key is to **specialize** in goods with a lower opportunity cost. This theory suggests countries should export goods they can produce at a lower relative cost and is a cornerstone of modern trade theory.

Heckscher-Ohlin (H-O) theory (early 20th century): This theory, also known as the factor endowment theory, explains comparative advantage based on differences in a nation's resources. It posits that countries will export goods that heavily utilize their abundant and cheap factors of production (like labor or capital) and import those that require scarce factors. **The Leontief Paradox in the 1950s** presented a challenge to this theory.

Modern theories

(firm-based)

- **Product life cycle theory (Raymond Vernon, 1960s)**: This theory describes how a product's **trade patterns change over its life cycle**. Initially, a product is developed and consumed in a developed country. As it matures, production and export shift to other developed nations, and eventually to developing countries with lower costs, which then export the standardized product.
- **New trade theory (Paul Krugman, 1980s)**: This theory uses economies of scale and network effects to explain trade between countries with similar resources (intra-industry trade). It suggests that countries can **specialize** in **specific niches** within an industry, allowing firms to achieve economies of scale and first-mover advantages..
- **Porter's diamond of national competitive advantage (Michael Porter, 1990)**: This model explains why certain nations excel in specific industries by identifying four key factors: **factor conditions** (resources), **demand conditions** (a strong domestic market), **related and supporting industries** (clusters of strong suppliers), and **firm strategy, structure, and rivalry** (intense domestic competition driving innovation).

Theory type	Theoretical emphasis	Credited writers
<i>International trade theories</i>		
Classical trade theory	Countries gain if each devotes resources to the production of goods and services in which it has an advantage	Ricardo (1817) Smith (1776)
Factor proportion theory	Countries will tend to specialize in the production of goods and services that utilize their most abundant resources	Heckscher and Ohlin (1933)
Product life cycle theory (for international trade)	The cycle follows that: a country's export strength builds; foreign production starts; foreign production becomes competitive in export markets; and import competition emerges in the country's home market	Vernon (1966, 1971) Wells (1968, 1969)
<i>Foreign direct investment theories</i>		
Market imperfections theory	The firm's decision to invest overseas is explained as a strategy to capitalize on certain capabilities not shared by competitors in foreign countries	Hymer (1970)
International production theory	The propensity of a firm to initiate foreign production will depend on the specific attractions of its home country compared with resource implications and advantages of locating in another country	Dunning (1980) Fayerweather (1982)
Internalization theory	Internalization concerns extending the direct operations of the firm and bringing under common ownership and control the activities conducted by intermediate markets that link the firm to customers. Firms will gain in creating their own internal market such that transactions can be carried out at a lower cost within the firm	Buckley (1982, 1988) Buckley and Casson (1976, 1985)

3- Implications of trade theories in International Business

Impact on International Trade

Ricardo's **comparative advantage theory** changed the way we understand international trade. Instead of focusing on absolute productivity, he showed that countries benefit from trade **even if they are less productive overall**—as long as they specialize in what they do best **relative to other nations**.

■ Modern Applications of Ricardo's Theories

1. Globalization and Specialization

Ricardo's theory is the foundation of **modern globalization**. Countries worldwide **specialize in industries where they have a comparative advantage**, leading to **lower costs and increased efficiency**. For example:

- **China** specializes in electronics manufacturing.
- **Brazil** focuses on agricultural exports like soybeans and coffee.
- **Germany** excels in automobile and precision engineering.

This specialization **reduces production costs and expands global markets**, benefiting both producers and consumers.

3- Implications of the trade theories in International Business

2. Trade Policies and Agreements

Modern **trade agreements** and **economic blocs**, such as the **European Union** and **NAFTA**, are **rooted in Ricardo's principles**. These agreements **lower tariffs and encourage economic cooperation**, fostering economic growth by allowing countries to **focus on their comparative advantages**.

2. Emerging Markets and Economic Growth

Developing nations use Ricardo's theory to **stimulate economic growth**. By identifying **comparative advantages**—such as **agriculture in Africa** or **textile production in South Asia**—these countries attract **foreign investment and expand their export markets**, reducing poverty and boosting development.

Summary:

theories of trade explain why it is beneficial for a country to engage in international trade and have explained the **pattern** of international trade that we observe in the world economy.

The different theories offer largely complementary explanations, although, no one theory may explain the apparent pattern of international trade... they suggest which factors are important.

References /links:

[Porter's Diamond Model explained with Real Helpful Examples](https://www.gktoday.in/porters-diamond-model-explained-with-real-helpful-examples)

<https://www.gktoday.in/porters-diamond-model-explained-with-real-helpful-examples>

<https://www.gktoday.in/porters-diamond-model-explained-with-real-helpful-examples>

<https://www.gktoday.in/porters-diamond-model-explained-with-real-helpful-examples>

<https://www.gktoday.in/porters-diamond-model-explained-with-real-helpful-examples>

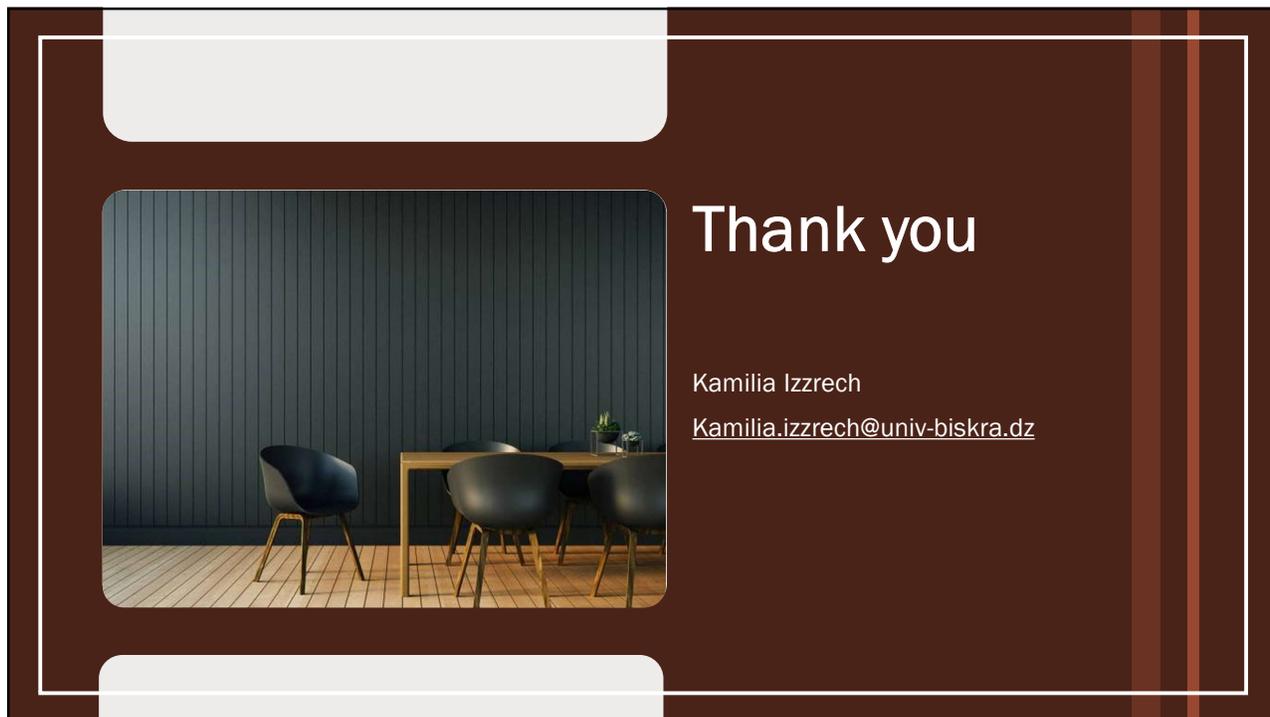
<https://www.gktoday.in/porters-diamond-model-explained-with-real-helpful-examples>

questions:

1- why international trade is important?

2- evaluate each theory of trade and give an example of a country or an economy that applies it.

3- what is the Difference Between Business, Commerce, and Trade?



[White rounded rectangular placeholder]



[White rounded rectangular placeholder]

Thank you

Kamilia Izzrech

Kamilia.izzrech@univ-biskra.dz