

*To what extent can theories on international trade contribute to the development of international business strategies?*

## **Introduction**

Science develops either after analysis and understanding of an existing phenomenon under use or by constant effort to understand behaviour of nature. Theories are developed for practical situations that go unanswered by the existing rules or theories. Theory, therefore, is but interpretation and legitimisation of the practices that are in vogue. Theory is developed since the understanding needed of practical situations is much more and the situations warrant for a greater research in understanding the normal operations of the business or technology. On many occasions, theory is an offshoot of the need to understand the practical issues rather than to develop something that is irrelevant to practical issues.

Similar is the case with the international trade. Theories have been developed into models to explain the complex structure that the international trade has. While international trade has been growing in leaps and bounds in the last few decades of human history, the understanding of the science behind it, the theoretical concepts that have been put in place were put under question. Many new issues came up which need to be answered by the model in every theory and when it failed modifications to the theory were brought in to ensure that the concepts are well understood and the practice is able to 'predict' based on the theory. Theories are developed when vagueness is noticed in the practice. A

mathematical equivalent or model is used to simulate and understand the phenomenon. Theories are expected to further the cause of the work undertaken and add more decision making capability and to understand the methodologies of operation of the elements that contribute to the working of the phenomenon. Though many of the man made objects fit into the known science and would work very much within it and under the control of the human masters, the market is one exemplary man made product that has eluded an 100% definition of its dynamics. International business is all the more complex because of the innumerable factors that act on its performance and the lack of forecasting methods for these factors.

### **International Business theories**

Since the time of Adam Smith, the theories on international trade have been studied, analysed and laid down for the practitioners to make use of. Though the first of the suggestions on the international trade theory was made by Adam Smith himself, it was left to David Ricardo to develop the concept into an explicit theory, called comparative cost doctrine.

This theory suggested two countries will be able to trade or do business together comfortably if there is a null balance of trade (Bastable, 1887). For instance, if Country A produces product P for cost C and the same product is produced by Country B at a cost of D. Similarly, another product Q which is produced by A at the price of E and by B at a cost of F, and if one country has a price advantage in product P and the other country has an advantage in product Q, then the countries will trade without any issues. However, if

one of the countries has an advantage while the other does not have any, then trading will be more one side which may not be comfortable and sooner or later the trade will be lost. Heckscher-Ohlin theory supplements this theory by specifying another factor that modifies the validity of the classical theory. This mentions the scarcity of a specific commodity in a country and the abundance of the same in another country. This is pretty relevant in the current scenario too since most of the trade in today's world is happening because of this factor, the abundance factor (Gottfried Haberler, Mar 1962).

International business conditions were dynamic and the insufficiencies of these theories were exposed soon. A number of alternate theories came up following the factor theory.

These theories made up for the factors that were not taken into consideration in the factor as well as in the classical theory. Linder brought in the demand factor at the destination country that alters the requirements and also intra-industry trade. The Ricardian theory was also proposed as a modifier on the classical theory to take care of the opportunity cost factor. When industrialisation reached its peak, it was found that large scale units could reduce the cost per unit drastically and the economies of scale came into the picture. Economies of scale suggest that exporters tend to get longer and larger production runs that result in better economical gain to the unit. In addition to this, the manufacturers could also realise a larger amount of division of labour initially within the territory they were working in. Soon the division of labour took major turns in getting jobs done from the cheapest point of source. This became an international sourcing exercise. Integrated development platforms across the world was expected to rope in

better gains to the company rather than have specific and localised vendors for components that go into manufacturing units.

In addition to this, Linder says (Vani V Kotcherlakota & Gandhi B Veluri, 2005) that the similarity in the economic status and policies of the destination country is very important for an ongoing trade. There should be similarities between two economies if product made in one has to sell in the other. If this does not exist, then in all probability the product made in one will not attract any attention in the other. Similarity of the economic scene between two countries is decided by the nature of the government there, demographic spread, the economic policies of the government, the purchasing power in the hands of the people and of course, the per capita income in the two countries under question. Linder calls this the theory of Overlapping Demand. This also implies that the countries should have similar economic, political and cultural structures if similar products need to be sold there. But most often this is not possible even with very similar economies and therefore, most of the products get localised before getting launched in specific projects. In addition to this, the countries also encourage their own sunrise industries and demote their sunset industries. All this would naturally affect the way business is done with the country.

Theories also propose the extent to which practical work gets affected during the implementation of a project. The dynamic nature of the environment and the socio-political implications of many of the products might not evoke the same kind of response in the destination country. This was exemplified by Linder's Overlapping model. He

further went on to say that the countries with similar economic structures would find it easier to do business as much as countries with similar social and political structures and hierarchies. It is easier for countries with similar practices to conduct business. This is also the case with ethics and with customs. In contrast, the factor endowment theory of Heckscher-Ohlin says that the countries with dissimilar economic structures alone will be more compatible to do trading (Robert J Carbaugh, 1992). The contradiction is in the approach to the economic theory and the possibility that business exists in dissimilar economies can not be ignored.

### **Theory and Practice**

Many of the industry practices go hand in hand with the theory. Or rather, the theory is extended to sort out any inconsistencies in the practice if it should arise. Economics of scale is extensively used to understand the dynamics of the target market. When the Chinese Pencillin G manufacturers wanted to take on the world, they had their scales increased. Already their scale of operation was large since they were catering to a larger market base in China. Their onslaught in the South Asia for instance, meant that three out of the four manufacturers in India, one in Singapore were closed down. The economies of scale were tilted highly in favour of the Chinese. A similar thing happened with the toys market in United States. When the Chinese toys hit the American market, there was a total swamping of the business with Chinese products. They were cheap and they were different. Naturally, today the Chinese are the number one toy makers in the world. Most of the foreign trade aggressiveness of companies has followed the theoretical

propositions to a great extent. Knowledge of the theory would help in countering such trade competition from another country.

A clear understanding of the Chinese pharmaceutical industry would help in understanding the weakness that they have. Chinese market is specifically strong in bulk drugs, like Pencillin G, Oxytetracycline, doxycycle, etc., But they are weak in formulations. The South Asian companies if they need to compete with the Chinese pharmaceutical industries need to ensure that they move over to the formulations space where there is little competition from the existing Chinese manufacturers; in addition, there is value addition to the product (Bhuma Shrivastav, 2 Nov 2006). While the Chinese leverage the economies of scale, the Indians and the Malays should leverage the Chinese market for these products that they can capitalise on and bring in balance of trade, if they have the strengths in them. This has been successfully employed by some of the Indian companies who have opened shop in China and build on the business. The same is true in the case of Microsoft and the toy war with China (China Daily, 11 Oct 2003). Whereas, there is no question of fighting the Chinese toys with the electronics that could be made in US which could turn out to be costly; but, Microsoft and Sony of Japan created a parallel stream of gaming stations that would take the products to a different level of programming and bring it out of the control of the Chinese to some extent. This strategy is an understanding of the theoretical concepts of international trade and applying the same for their purpose (E&Y, 2005).

Environmental and social problems in US forced many of the pesticide and environmentally unfriendly chemical manufacturers to move out of US to third world countries where such rules were either minimal or non-existent (Ellen Hosmer, Jul/Aug 1997). The destination country's internal laws and regulations decide on the nature of goods that come in or go out of the country. This is applicable to both the exporting country as well as the importing one. The practice of international trade is not far from the theoretical studies that have been conducted and researched upon. It is important to note that most of the decisions made by the companies for a strong and healthy international trade banks heavily on the theoretical possibilities. It would not make good sense to export bananas to Brazil. The corporate plan should vibrate well with the existing situations in the ground.

Most of the companies today, ensure that the requirements of the country are widely studied before any specific effort is made in trading with that country. For instance, before trading with countries in Africa, the companies ensure that the happenings are in line with the requirements in those locations and they themselves are not taken for a ride by people from these countries. Social culture and laws of the land count before deciding on the nature of business that the company chooses to do. This is exemplified by the services provided by companies like Dun and Bradstreet on the nature of the buyer and their profiles; the country and its pros and cons. Many of the modern factors that affect international trading have been theorised. For instance, the transportation costs, trade volume and business services have started affecting the international trade as indicated in the research and theoretical studies. In the late nineteenth century, UK exported Ice to

India! The price difference and the transportation cost was still manageable. But today, Japanese do not find it economical to export cars to Canada directly. It has to be brought into US and then sold to Canada. It is not economical to bring in automobiles direct to Canada because of the transportation cost. Similarly, business volume may not make it economical in some cases to import or export to the specific destination. There might be buyers for gold and platinum jewellery in Ivory Coast but it is not economical since the volumes may not really be good enough. Application of theoretical models would help the companies to realise the advantages and disadvantages and simulate the happenings in the countries world wide to know the effect of a business or trade with them.

In line with the factor endowment theory, differing systems of economic structure has also been doing extremely good business. For instance, the countries of USSR and India are highly dissimilar economies. While USSR was a totally controlled economy, India was free albeit with 30~40% controls in place like any other western country to support and augment their own internal industry. But the trade flourished between the two countries because of a strong bilateral commitment both had. This was seen as an example of the factor endowment dissimilar economic structures doing business with each other. This continued till the very fall of the USSR economy.

### **Advantages of applying theory to practice**

As said in the earlier section, applying the theory and simulating the entire business model with the target country would enable the company to realise the pros and cons that play a vital role in the business. Parameters that affect the performance of the trade

between the countries, the strengths and the weaknesses have to be listed in order to realise the advantages and disadvantages of making the deal. This would help the company in formulating a plan that would work. The international business was vague in the initial days. Over a period of time, the merging of the international economy has contributed to making the world wide business environment more comfortable to operate. However, still the changes in the environment due to uncontrolled factors like war, environmental changes, social changes and more recently, terror, continue to exist. Trying to understand the uncertainties and the extent to which the company is able to foresee into the future enables them to realise higher benefits. The models help the company to understand and simulate a condition in the future and try to see to what extent the business would get affected by the situations in the destination country for a change in the host country.

Changes could be happening in both the ends. The host country also could go in for a major overhauling in their political policies or actions that were initiated by the host country could cause specific changes in the behavioural pattern of the destination country. These changes can be simulated and addressed to using the models on theoretical studies. With the economy moving further towards the service sector and more than 50% of GDP inflow in most of the developed countries coming from the service sector, the nature of work that has to be done should be clear when providing the service to a foreign country. Most of the management consultants are based in US or UK and cater to the requirements of the clients' world over. In line with the needs of the client company, the service provider has to also look at the extent to which the cultural

and social differences between the two countries exist and to what extent the expectations are narrowed down. In some locations, asking for a detailed written letter on the scope of work could cause the client to walk away since they just might not be looking at the letter as a professional piece of work but instead might look at it as a stigma on their understanding and memory!

It is important that the cultural and economic structure in the target country is more clearly analysed before embarking on the work of exporting to the country. Theories on international trade specify that trade is possible under certain conditions. From the classic to the contemporary theories, every one of them suggests methods that would help in visualising / modelling the entire scene. Theory will help companies who are keen in doing business with a country, to identify the gaps in the trade and the needs of the destination country. Trade to the country need necessarily adapt to the theory; though it might be beyond it and the creativity and ingenuity of the business person is also critical in making use of the available gaps in the trade. It is very important that the company ensures that their product fit one of these gaps and will be making a headway in the destination country's market. When Daewoo opened a Uzbekistan production centre to cater to the needs of Europe and Uzbekistan for a mid size and luxury sedan, they had done enough survey in the country to realise that the requirements of the country (Uzbek in this case) can be met with just 50% of their scaled capacity and the rest needs to be marketed elsewhere (John A Quelch & Chanhi Park, 20 Oct 1997). The analysis involved not just the market study, the acceptance of the product in the country and the region, but also the economies of scale, overlapping demand segments and other factors. Even when

the Daewoo empire fell, the Uz-Daewoo was still going strong, after the initial hiccups that it faced like any other new venture.

In the services sector too, any export of service without taking into consideration the various possibilities in the destination location could lead to a failure. Euro Disney is a classic example of a venture that did not follow the rules of the game and landed themselves in trouble unlike the Tokyo Disney (Robert M Grant, 2002). Euro Disney did not take into account, the local social preferences and customs in the destination country. Even if the economic levels of the destination country matched with the ones in the source country, the perception of the people differ and their intention to spend money also changes. Their customs and habits are different from the ones practiced in the source country. If these are not taken into account, it would certainly find itself in a fix. This is particularly true of the service industry where such decisions cost Euro Disney a major trial during its initial days of existence.

## **Conclusion**

International trade and the mechanism that the international trade adopts is still a puzzle under certain conditions. There are known areas and the unknown areas where work need to progress. Research has thrown up theories that crystallise and try to establish the dynamics followed by the known areas of work. Business and trade need to make use of these existing theories so that they are able to realise the advantages of predicting the unpredictable. To the extent that the markets have been understood, it is important that the theories are applied and the possibilities are exhausted. Only then the venture that the

business tries is fully thought out and ensures success as much as possible. It will be not an intelligent act to jump into the fray without taking into consideration the various possibilities that are already known to affect international trade.

It is imperative that business makes use of the theories to the maximum extent possible and those businesses that ignore them do so at their own peril.

### References

1. Bastable J, 1887, The Theory of International Trade.
2. Bhuma Shrivastav, 9 Nov 2006, Pharma Industry on Trial, Business Standard, available at: <http://www.business-standard.com/sme/storypage.php?leftnm=13&subLeft=1&chklogin=Y&autono=264275&tab=r>
3. China Daily, 11 Oct 2003, International Toy makers try to solve China Market Puzzle, available at: <http://www.china.org.cn/english/BAT/77046.htm>
4. E&Y Report, 2005, China and India: Risks and Returns in Asia's Blockbuster Pharma Markets, Ernst & Young, available at: [http://www.ey.com/global/download.nsf/US/China\\_and\\_India\\_-\\_Risk\\_and>Returns/\\$file/NM\\_Pharma\\_Report\\_Asia\\_Blockbuster\\_Markets.pdf](http://www.ey.com/global/download.nsf/US/China_and_India_-_Risk_and>Returns/$file/NM_Pharma_Report_Asia_Blockbuster_Markets.pdf)
5. Ellen Hosmer, Jul/Aug 1990, The South's Day in Court, Multinational Monitor.
6. Gottfried Haberler, Mar 1962, A Survey of International trade theory, Journal of American Statistical Association, Vol 57, No 297, pp 261-262, doi: 10.2307/2282486

7. John A Quelch, Chanhi Park, 20 Oct 1997, Daewoo's Globalisation: Uz-Daewoo Auto Project, Harvard Business Online, DOI: 10.1225/598065
8. Robert J Carbaugh, 1992, International Economics, South Western Educational Publishing, ISBN: 0534145388
9. Robert M Grant, 2002, Euro Disney: From Dream to Nightmare 1987-1994, Contemporary Strategy Analysis, Fifth Edition, Blackwell Publishing.
10. Vani V Kotcherlakota, Gandhi B Veluri, 2005, Alternative Theories of International Trade, available at: [http://www.nssa.us/nssajrnl/25\\_1/13-Kotcherlakota-Alternative.htm](http://www.nssa.us/nssajrnl/25_1/13-Kotcherlakota-Alternative.htm)

## **Annexure**

### Theories on International Trade

<b>Author</b>	<b>Theory</b>	<b>Year</b>
Adam Smith	Theory of Absolute Advantage	1776
David Ricardo	Theory of Comparative Advantage	1815
G. Huberler	Theory of International Trade (Restatement of Classical Theory)	1936
J.S. Mill	Theory of Reciprocal Demand	1944
E.F. Heckscher	H-O Theory	1919
B. Ohlin	H-O Theory	1933
S. Linder	Theory of Overlapping Demands Intra Industry Trade	1961
M.V. Posner	International Trade and Technical Changes	1961
R. Vernon.	Product Life Cycle Theory	1966
H.J Grubel and P.J. Lloyd	Intra-Industry Trade Index	1975
P.R. Krugman	Scale Economics and Product Differentiation	1979
L. Lancaster	Intra-Industry Trade Under Perfect Monopolistic Competition	1980
Helpman	Monopolistic Competition in Trade	1981, 1984,

A. Deardroff	Theory Gravity Analysis	1987, 1989 1997
--------------	----------------------------	--------------------