International Trade Theory and Practice

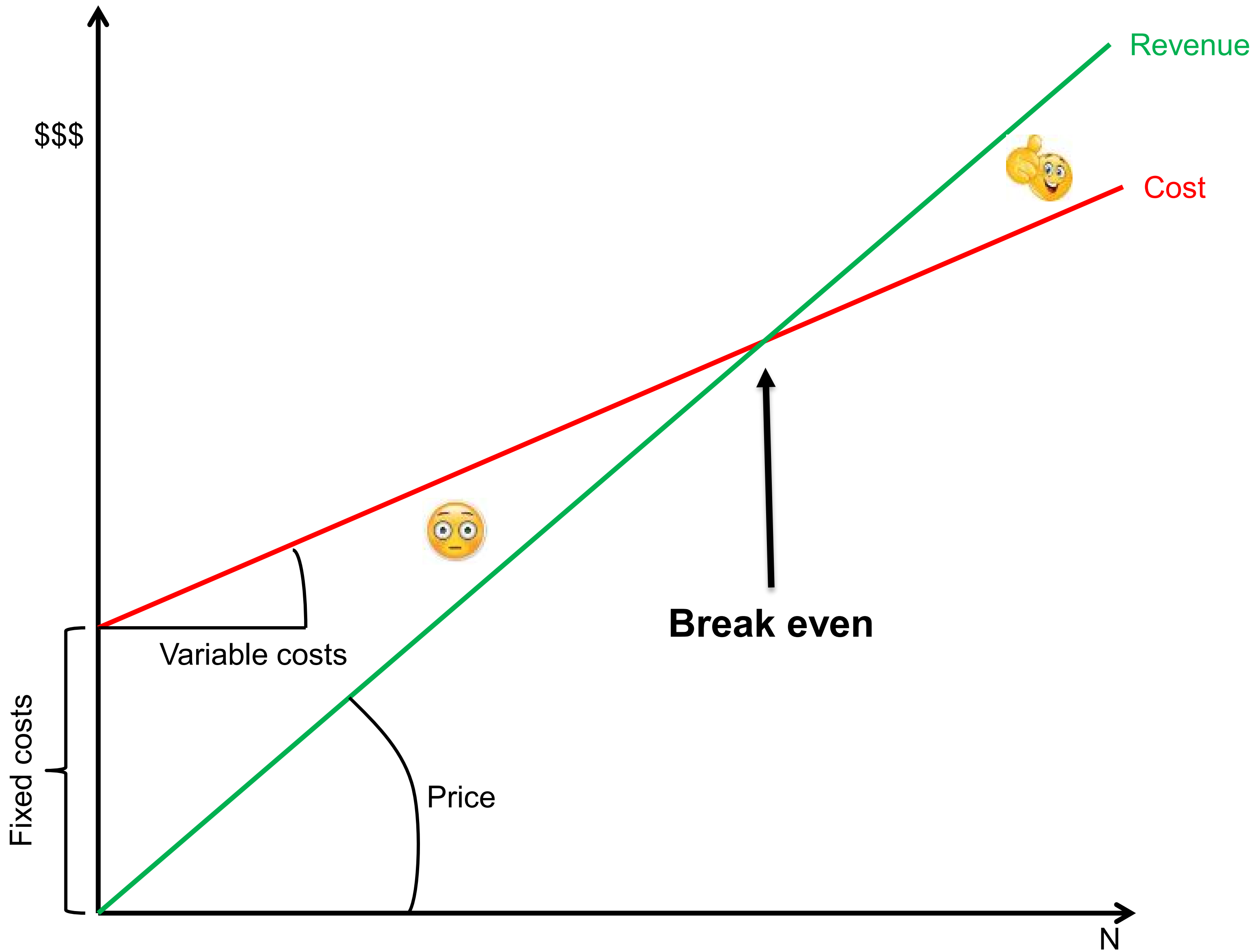
Learning Objectives

- Overall international trade patterns
- Theories explaining trade flows
- Different types of export activities
- Payment options for trade

Why Firms Engage in Foreign Trade?

Exporters ⟺ **Importers**

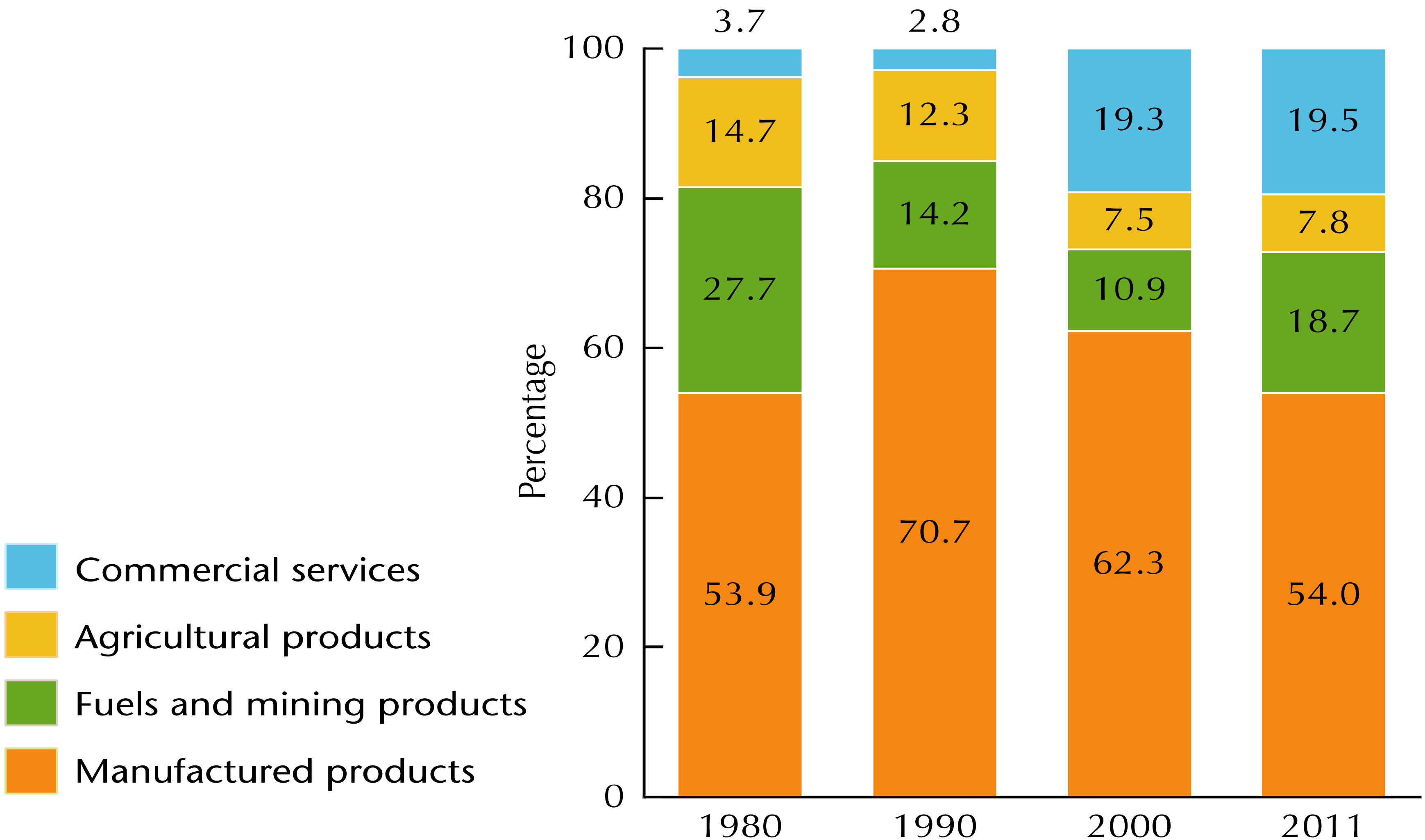
The Economy of Scale



Trends in International Trade

- Most of world merchandise trade is represented by manufactured goods
- After WWII: strong growth in world trade volume (manufactures)
- Since 1980s: strong growth in services trade, app. 23% of total world trade today
- Digital trade, e-commerce

Worldwide Trade by Major Sectors



World’s top exported goods

Rank	Product	2017 Export Sales	Since 2013
1.	Crude oil	$843.8 billion	-46%
2.	Cars	$749.2 billion	+10.6%
3.	Processed petroleum oils	$658.2 billion	-37%
4.	Integrated circuits/microassemblies	$623.5 billion	+23.8%
5.	Phone system devices including smartphones	$562.4 billion	+17.7%
6.	Automobile parts/accessories	$388.7 billion	+6.6%
7.	Computers, optical readers	$334.1 billion	-3%
8.	Medication mixes in dosage	$328.5 billion	+0.6%
9.	Gold (unwrought)	$321.3 billion	-32.8%
10.	Petroleum gases	$272.2 billion	-40.2%

Source: CIA The World Factbook

World's top exporting countries

Economy	Million US Dollars
European Union	5,813,235.6
China	2,499,028.9
United States	1,645,625.5
Germany	1,489,158.4
Netherlands	709,229.5
Japan	705,528.3
France	569,731.6
Korea, Republic of	542,232.6
Hong Kong, China	534,887.3
Italy	532,663.2
United Kingdom	468,817.4
Mexico	461,115.6

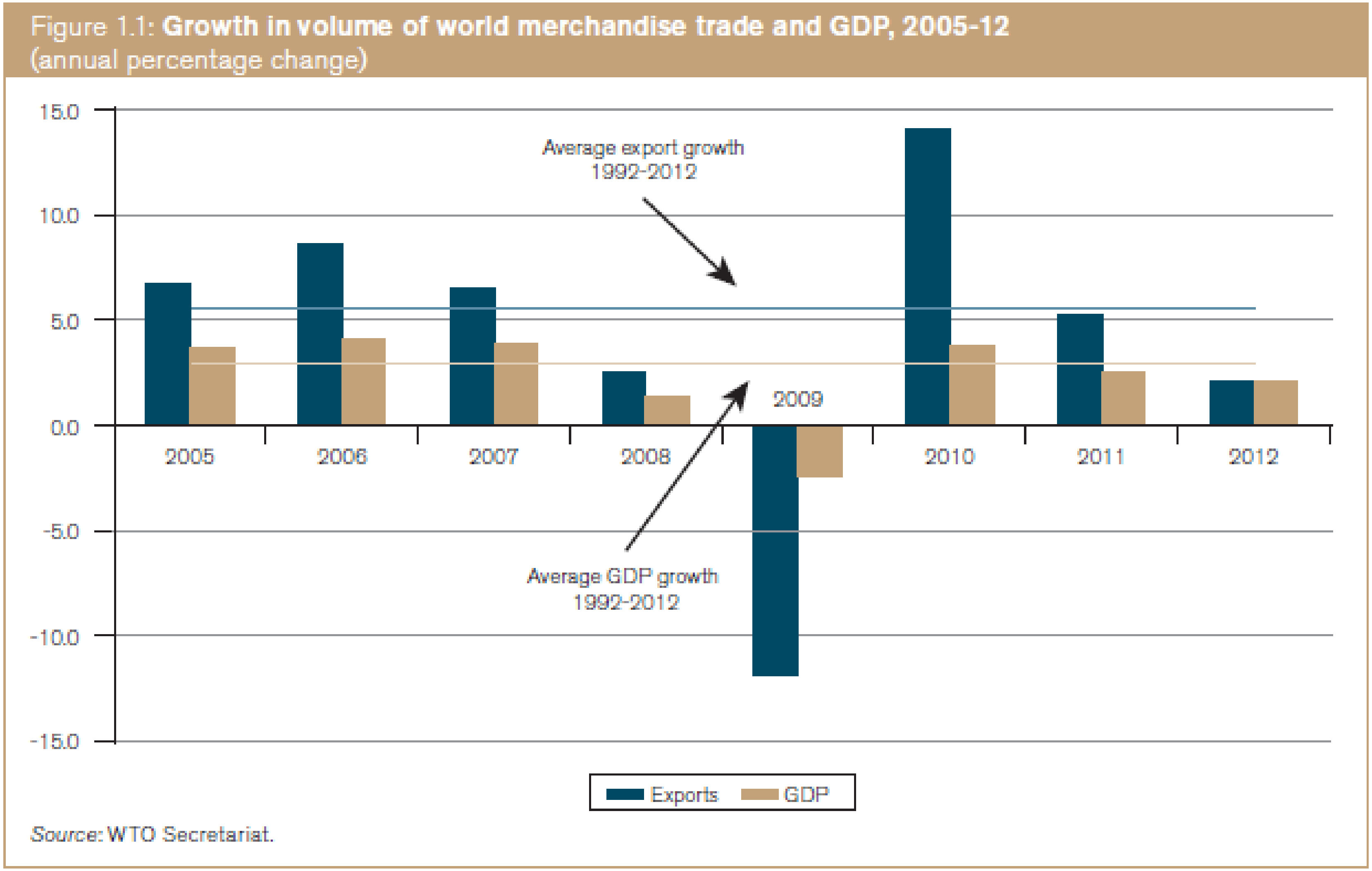
Merchandise exports 2019
Source: WTO

World's top importing countries

Economy	Million US Dollars
European Union	5,526,696.1
United States	2,568,406.9
China	2,077,097.1
Germany	1,234,222.2
Japan	720,737.7
United Kingdom	691,800.5
France	651,178.9
Netherlands	635,967.4
Hong Kong, China	577,834.2
Korea, Republic of	503,342.9
India	483,863.9
Italy	473,511.7

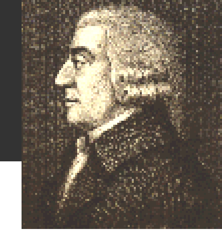
Merchandise imports 2019
Source: WTO

World Trade Report (WTO, 2013)

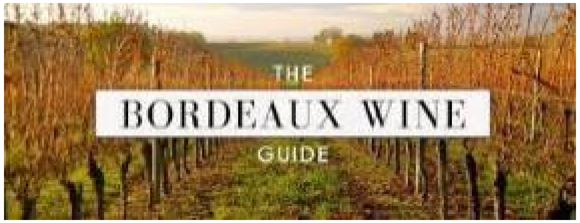


Q: Why are the blue bars almost always longer than the brown ones ?

Absolute Advantage Theory



- Adam Smith, *Wealth of Nations* (1776)
- Free trade benefits nations since it facilitates specialisation of production
- A nation with an <u>absolute advantage</u> is able to produce greater output of a good or service than other nations using the same amount of, or fewer, resources
- Trade is a positive-sum game



Scenario example

- US productivity
  - One product A (30K USD) / 100 labor-hours
  - Ten product B (30K USD) / 120 labor-hours
  - Twenty product C (30K USD) / 150 labor-hours
- Australia productivity
  - One product A (30K USD) / 110 labor-hours
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- Greece productivity
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Comparative Advantage Theory

- David Ricardo, *Principles of Political Economy* (1817)
- Extended free trade argument
- If one country holds an absolute advantage in the production of two products, specialisation and trade could still benefit both countries
- A country has a comparative advantage when it is able to produce a good more efficiently than it does any other good
- Trade is a positive-sum game

Scenario example

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Theories of Specialisation

- Both absolute and comparative advantage theories are based on specialization
- Based on this theoretical argument, free trade is good for everyone
- Arguments against free trade:
  - 1
  - 2
  - 3
  - 4
  - …

Theories of Specialisation

- Both absolute and comparative advantage theories are based on specialization
- Based on this theoretical argument, free trade is good for everyone
- Arguments against free trade:
  – 1 factor mobility
  – 2 no overcapacity (full employment)
  – 3 efficiency driven
  – 4 transaction/transportation costs
  – …

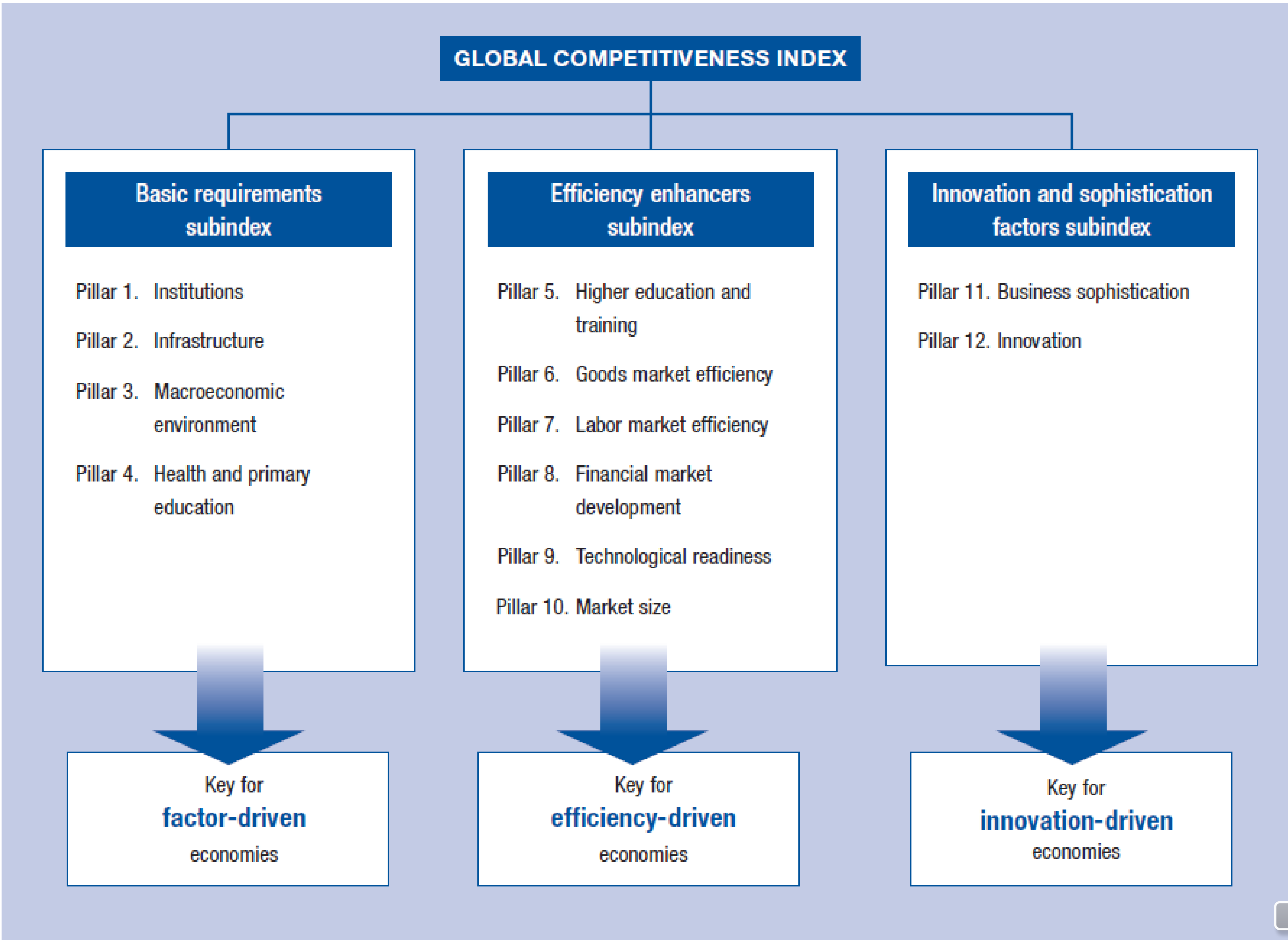
Factor Proportions Theory

- Heckscher and Ohlin (1920s-1930s)
- Countries:
  - Produce and export goods requiring resources (production factors) that are abundant
  - Import goods requiring resources in short supply
- Differences in factor endowments determine patterns of international trade

Competitive Advantage (Porter)

Source: Porter, M. E., 1990, *The Competitive Advantage of Nations,* and from R. Grant, 'Porter's 'Competitive Advantage of Nations': An Assessment', *Strategic Management Journal*, Vol. 12, No. 7, 1991, pp. 535-48

Global Competitiveness Report 2013-2014



Source: World Economic Forum

The resource-based view

Strategic capabilities and competitive advantage

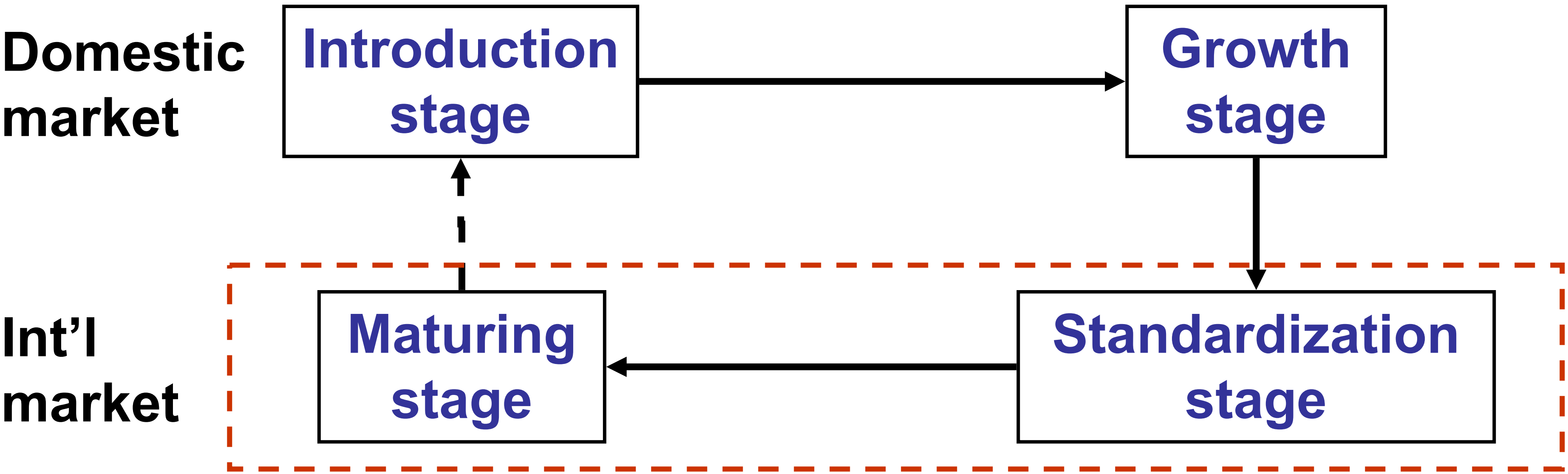
The four key criteria by which capabilities can be assessed in terms of providing a basis for achieving *sustainable* competitive advantage are:

- ***value,***
- ***rarity,***
- ***inimitability and***
- ***non-substitutability***

VRIN

Source: Jay Barney: 'Firm resources and sustained competitive advantage', *Journal of Management*, vol. 17 (1991), no. 1, pp. 99–120.

International Product Life Cycle (Vernon, 1966)



Traditional vs. Born-global

Types of export

	Passive	Active
Indirect	▪ ETC	▪ EMC ▪ Agent ▪ Distributor
Direct	▪ Piggy-backing	▪ Direct selling ▪ Sales subsidiary

Compare the intermediaries

- Location:
  - Home-based: EMC, ETC
  - Foreign-based: agent, distributor
- Transaction:
  - Taking title: ETC, distributor
  - Not taking title: EMC, agent
- Exporter’s control:
  - High: EMC, agent
  - Medium: distributor
  - Low: ETC

ETCs	Vs.	EMCs
take title to goods		do not take title to goods
pay product price		charge commission
fully handle IL		facilitate IL
broad coverage		often specialized
large entities		small entities
no learning opportunity		learning opportunities

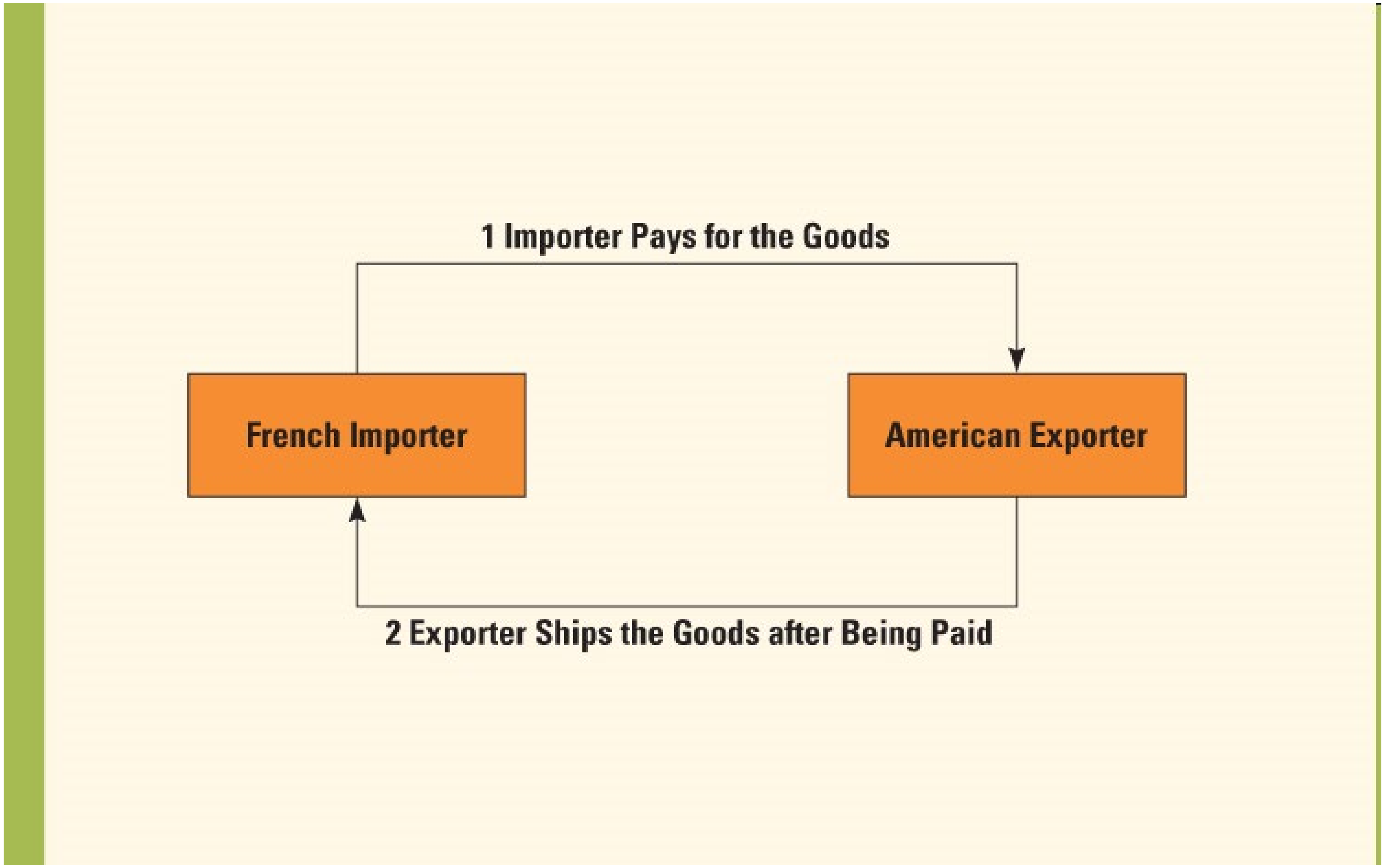
Distributors	Vs.	Agents
take title to goods		do not take title to goods
pay product price		charge commission
large entities		small entities / individuals
generally legal		illegal in some countries
contract law		labour law
high switch cost		high switch cost

	Litigation	Arbitration	Mediation
Procedure	Formal	Formal	Informal
Efficiency	Low	High	High
Effectiveness	Low	High	High
Privacy	No	Moderate	High
Decision	Binding	Binding	Non-binding
Relationship	Hurt	Hurt	maintained

Trade payment methods

Term of payment	**Exporter security**	**Importer convenience**
Cash in Advance	*High*	*Nil*
Letter of Credit	*Fairly High*	*Low*
Doc. Collection	*Low*	*Moderate*
Open Account	*Nil*	*High*

Case in advance



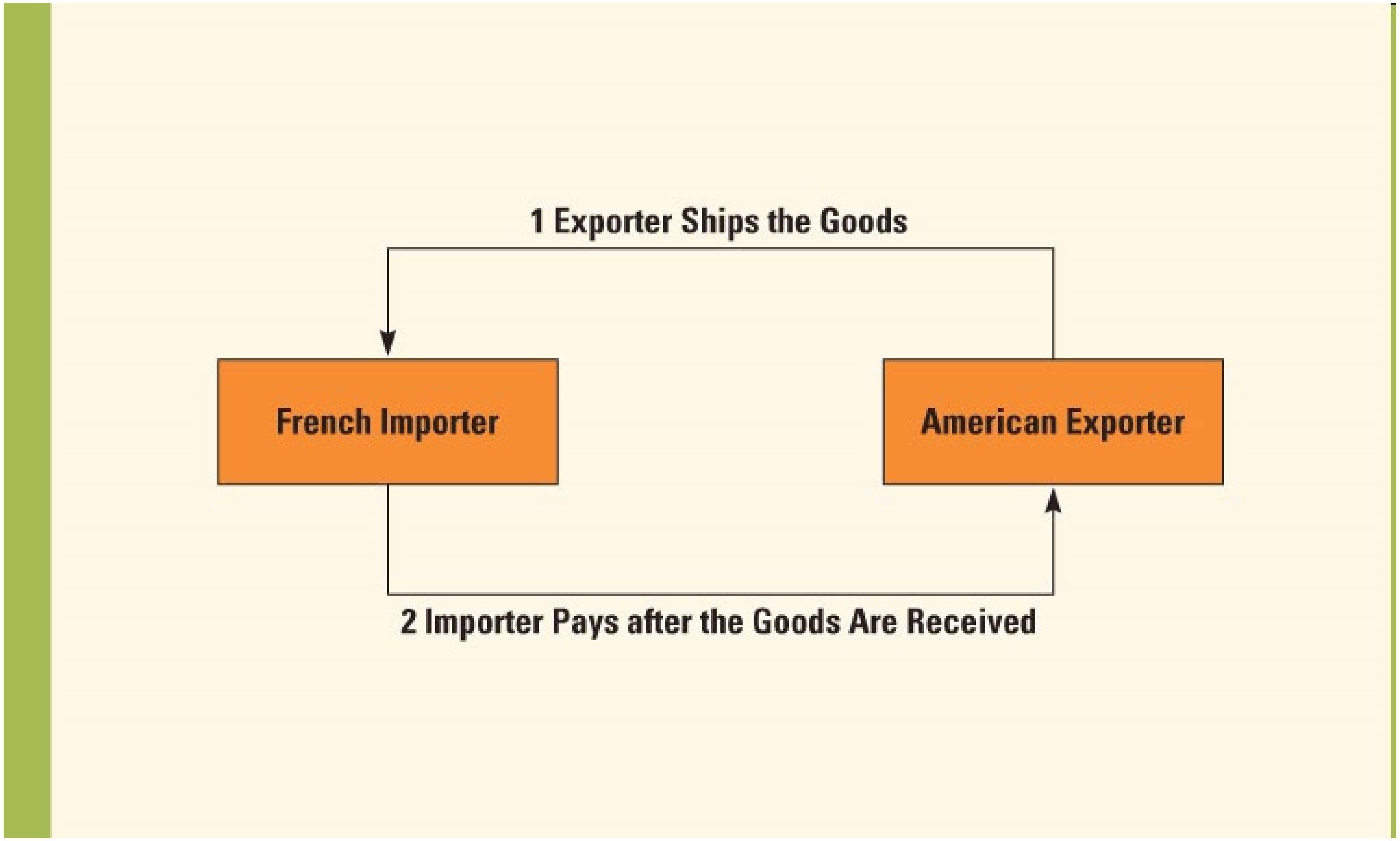
Cash in Advance

- Payment by importer before shipment
- Risk free for exporter
- Risk transferred to importer

When to use?

- Import country unstable
- Import country FX control
- Buyer has bad credit rating
- Goods made to order

Open Account



- Credit insurance
- Factoring

Open Account

Cash on delivery

- Exporter invoices importer after shipment
- Importer pays on delivery or later
- Domestic and EU standard

When to use?

- Buyer has good credit rating
- Low country risk
- Internal transaction
- Strategic or competitive needs

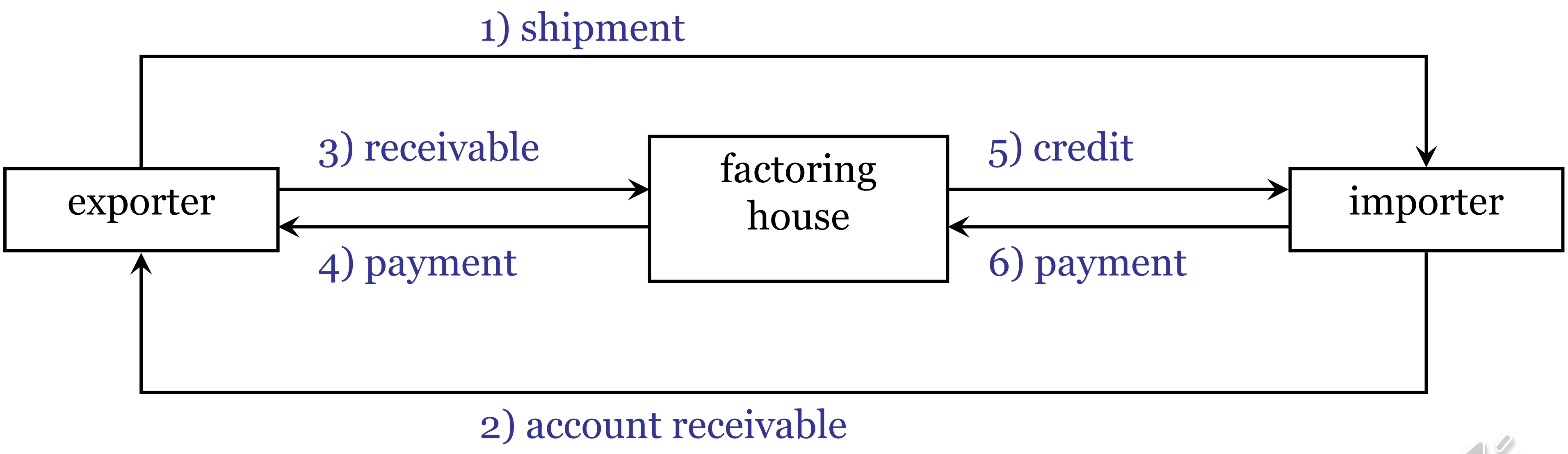
Securing Open Account

Credit insurance

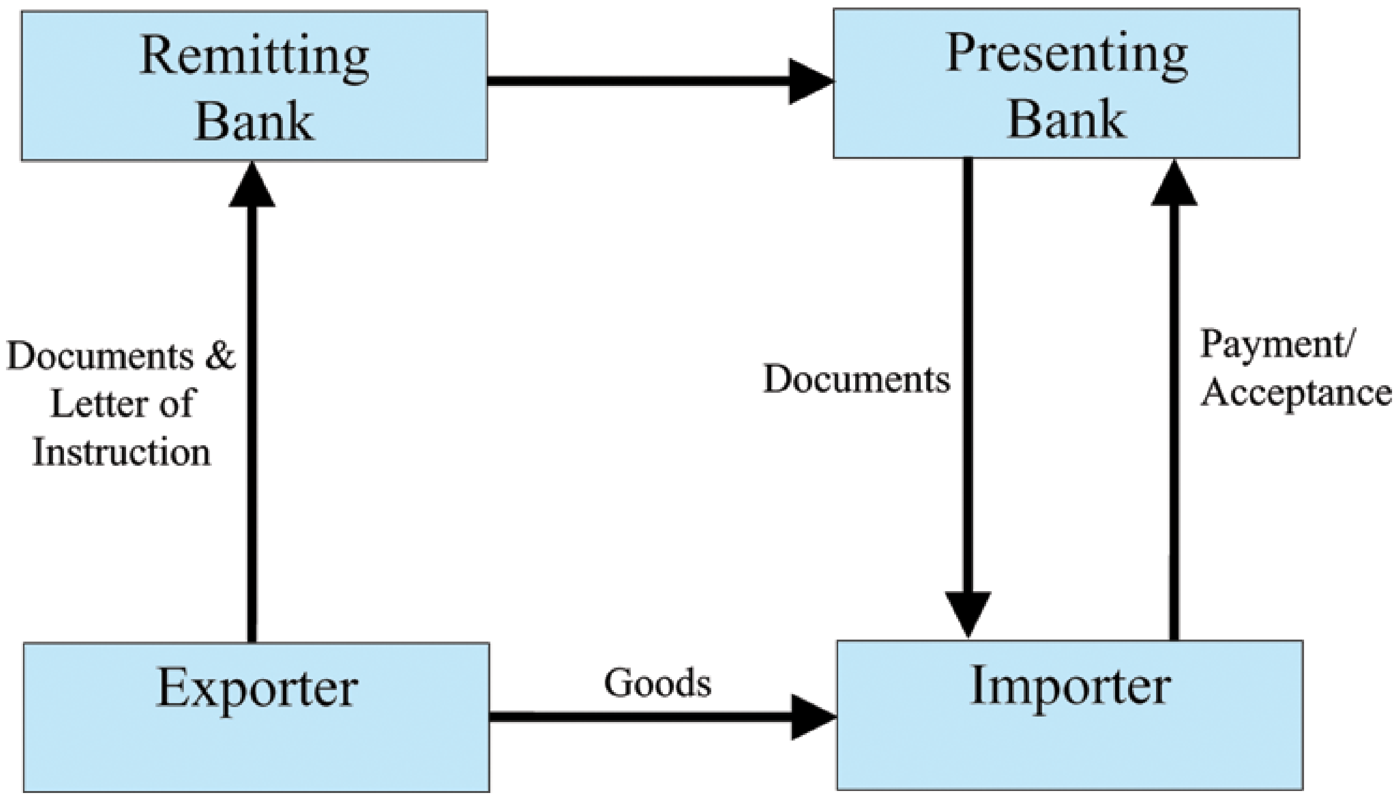
– standard cover (commercial risks)

– optional cover (country risks)

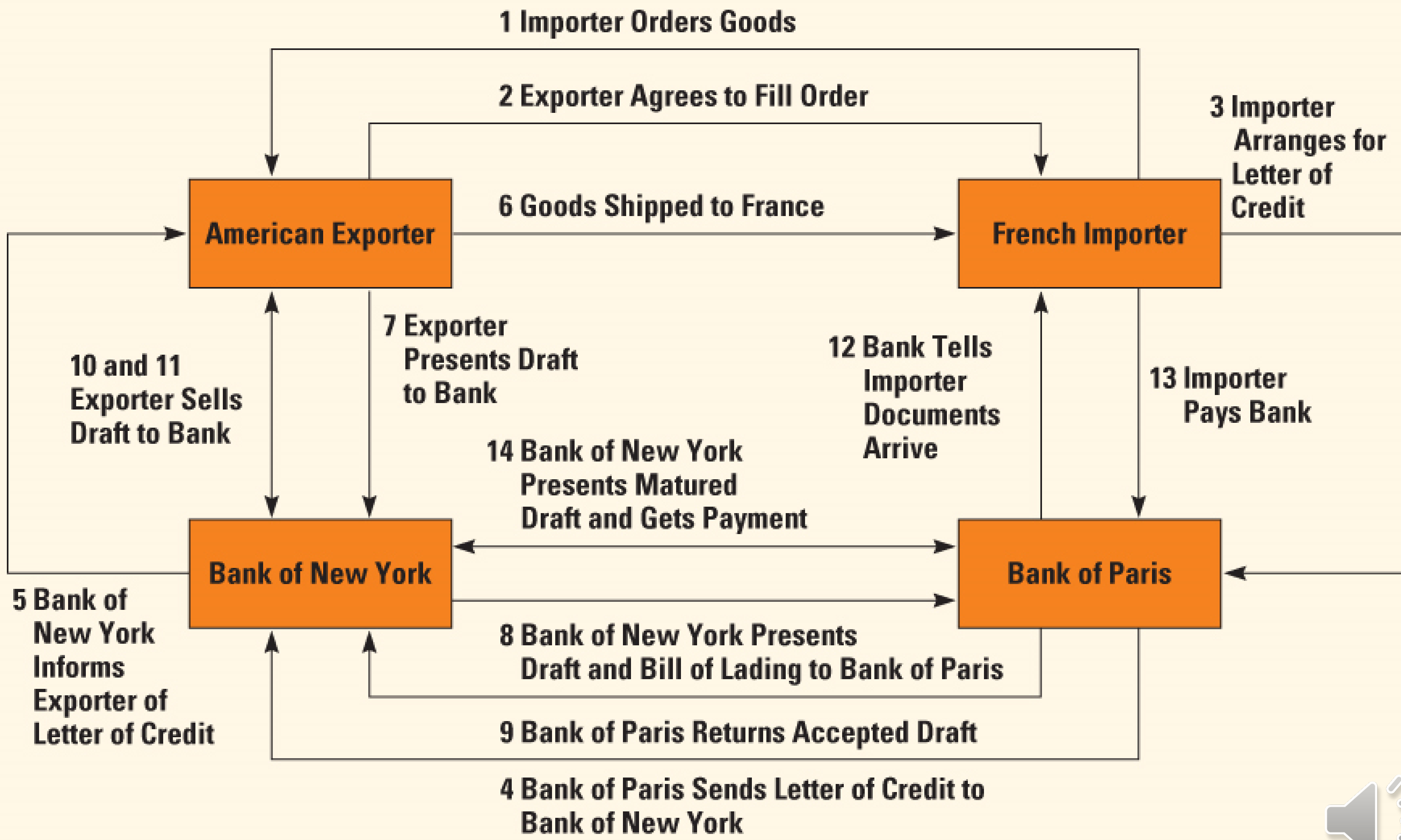
International factoring



Document collection

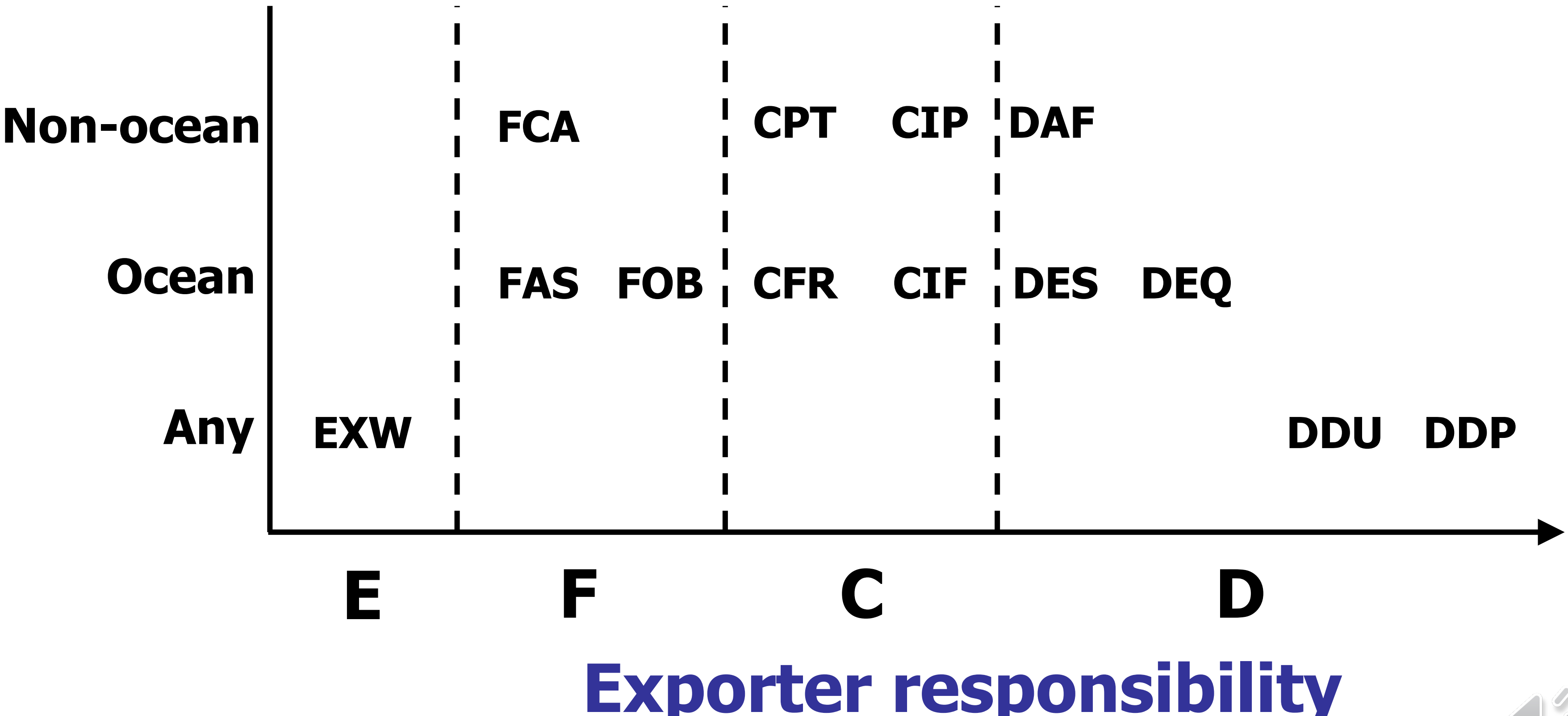


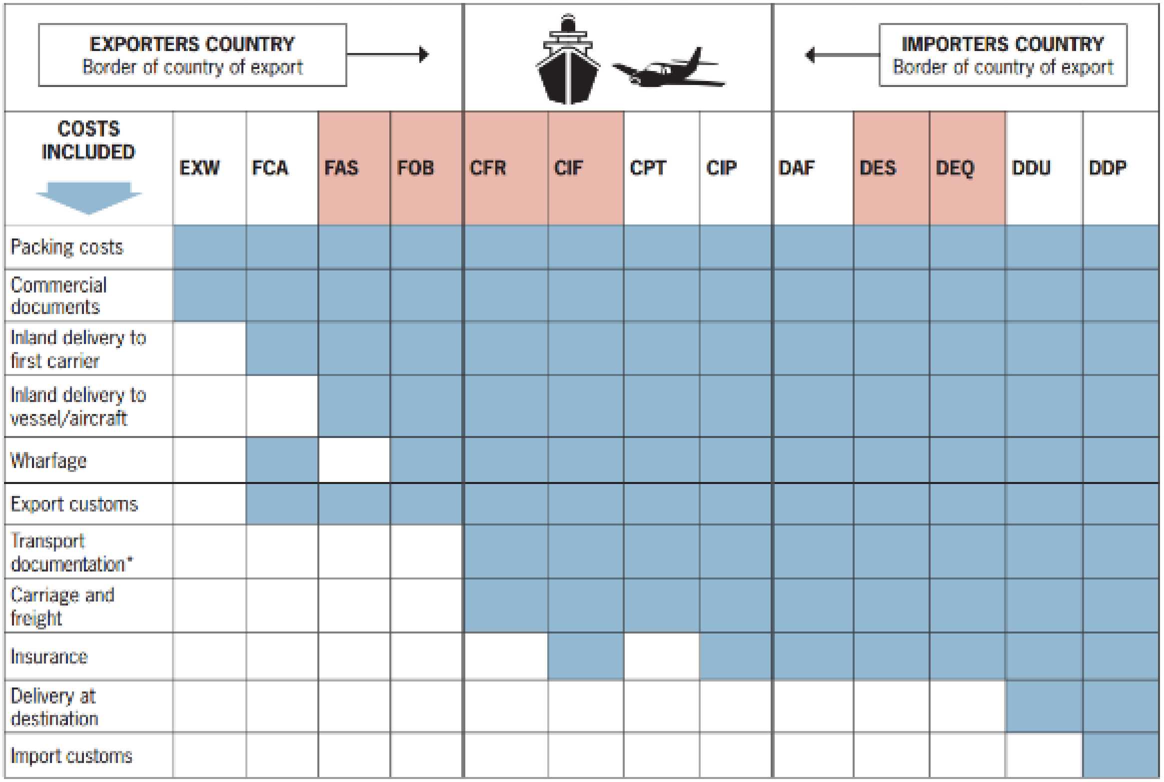
Letter of Credit (L/C)



Incoterms conditions

Transportation Modes





	Costs recommended for sea freight only
*	The cost of obtaining an airway bill or bill of lading should still be included in the Free on Board (FOB) value, as they are an essential element of getting the goods on board.

Reference material can be purchased from the International Chamber of Commerce's website, www.iccbooks.com

Incoterms acronyms

- CFR - Cost and freight
- CIF - Cost, insurance and freight
- CIP - Carriage and insurance paid to
- CPT - Carriage paid to
- DAF - Delivered at frontier
- DDP - Delivered duty paid
- DDU - Delivered duty unpaid
- DEQ - Delivery ex quay
- DES - Delivery ex ship
- EXW - Ex works
- FAS - Free alongside ship
- FCA - Free carrier
- FOB - Free on board

Please note: this fact sheet is a general guide only.

For more information on any Customs and Border Protection matter, contact the Customs Information and Support Centre on 1300 363 263 or email information@customs.gov.au or browse the website www.customs.gov.au

October 2009

Use of Incoterm:

- Quoting
- Negotiating

Source:

Australian Government
Australian Customs and Border Protection Service

Implications for Managers

- Market-seeking efforts
  - Export to expand sales, import to secure supply chain
- Location implication
  - Countries differ in their advantages for different industries
- Select appropriate export mode and intermediary
- Use payment options and incoterm to secure trade transaction