LEARNING OBJECTIVE 7.1 Compare theories about why countries trade.

Trade theories argue that governments directly affect trade through intervention, such as in mercantilism and neo-mercantilism, and by free-trade policies enacted when a country has an absolute or comparative advantage. Some theories suggest that trade is a function of factor availability or overlapping demand, or that it is due to a product's life cycle or to industry clusters. Still another theory argues that trade reflects a company's desire to achieve economies of scale.

Trade theories:

- **Mercantilism** a trade theory which suggests that trade generates wealth for a country with a trade surplus, with emphasis on colonization and military conquest
- **Neo-mercantilism** a trade theory which suggests that trade generates wealth for a country with a trade surplus, with emphasis on rapid economic development
    - **Protectionism: tariffs**, which are taxes on foreign products meant to discourage imports; **subsidies**, which are price supports for industries, thereby encouraging exports; and **monetary measures**, which are government actions related to the supply of money in order to keep its currency, the renminbi, significantly undervalued
- **Theory of Absolute Advantage:** Countries that were better at producing a specific good or service than any rival had an absolute advantage in the production of that good
    - increasing productivity and wealth for both countries
- **Theory of Comparative Advantage:** the ability of a country to produce a specific good or service at a lower opportunity cost than a rival
- **Heckscher-Ohlin theory of trade** a theory that suggests that trade flows from countries with abundant factor endowments to countries with scarce factor endowments
    - oil-rich Saudi Arabia is more likely to trade with technology-rich Germany than with oil-rich Russia
- **Theory of overlapping demand:** suggests that trade is the result of customer demand and that customers of similar wealth are likely to demand similar products and services
    - Rich countries will trade with rich countries with similar customer needs, and poorer countries will trade with poorer countries with similar customer needs
- **Theory of the International Product Life Cycle:** Suggests that the level of trade in a product at any given time is a function of the current stage in the product's life cycle, in which life cycle consists of introduction, maturity, standardization, and decline

LEARNING OBJECTIVE 7.2 Describe trade imbalances and their consequences.

Trade is accounted for in the balance of payments, that is, in the current account (which measures the balance of trade for goods and services) and the capital account (which measures the transfer of capital to and from other countries). Globally, trade deficits and surpluses must balance. At the country level, countries with a surplus invest that surplus into countries with deficits, either by lending money to the country with the deficit or by purchasing assets from it.

- **Theory of underconsumption** a theory which states that recessions are the result of insufficient demand relative to the supply, and underconsumption is often caused by wealth inequality
- **Infant industry theory a** theory which states that certain emerging industries need to be protected and nurtured for a period of time or they will be unable to compete against established foreign firms
- **General Agreement on Tariffs and Trade (GATT)** a treaty that has the purpose of reducing trade barriers and tariffs while eliminating trade preferences and providing a multilateral forum to resolve trade disputes between member countries
- **Protectionist policies:**
    - **quota** a direct limit on the number of goods that can be imported into or exported from a country
    - **tariffs** taxes on foreign products that discourage imports
    - **subsidies** government support for industries
    - **antidumping** actions a class of protective tariffs imposed by a domestic government on foreign imports that are thought to be priced below fair market value
    - **content requirements** a minimum level of materials, parts, or inputs that must originate in the local country rather than be imported
    - **embargo** a quota that limits all forms of trade on entire categories of goods or services

LEARNING OBJECTIVE 7.3 Identify patterns of trade such as regionalization.

International trade is akin to a prisoner's dilemma in which each country is better off maintaining trade restrictions while trading with partners that have no restrictions. Because of these dynamics, multilateral trade organizations, bilateral trade deals, and regional trade blocs have formed to encourage freer trade, enforce existing trade deals, and resolve trade disputes.

LEARNING OBJECTIVE 7.4 Classify government policies that affect trade patterns.

While many people argue for free trade, governments may have specific reasons to affect trade patterns and the tools to do it. These tools include import tariffs, export tariffs, subsidies, loans, quotas, local content requirements, standards, administrative delay, countertrade requirements, and embargoes. All these tactics seek to alter the efficacy of trade, often to protect or promote domestic companies.