REVISITING INTERNATIONAL TRADE THEORIES: CLASSICAL FOUNDATIONS AND MODERN EXPLANATIONS OF GLOBAL TRADE

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ABSTRACT

This paper examines the evolution of international trade theories and their relevance as foundational frameworks for international trade law, with particular emphasis on classical, neoclassical, and modern approaches. It begins by analysing early country-based theories such as Mercantilism, Absolute Advantage, and Comparative Advantage, which explain trade through differences in productivity, labour costs, and relative efficiency. The discussion then moves to the Heckscher-Ohlin theory, which advances trade analysis by linking comparative advantage to relative factor endowments and factor prices, while also engaging with its empirical limitations through the Leontief Paradox. The paper critically evaluates the assumptions underlying classical and neoclassical theories, highlighting their limited ability to explain intra-industry trade, economies of scale, and firm-level dynamics in contemporary global markets. To address these gaps, the study explores modern firm-based theories, including Country Similarity Theory, Product Life Cycle Theory, New Trade Theory, Strategic Rivalry Theory, and Porter's National Competitive Advantage. By integrating these perspectives, the paper demonstrates that modern international trade is shaped by innovation, scale, market structure, and strategic behaviour alongside traditional comparative advantage. The analysis underscores the importance of combining multiple theoretical approaches to understand present-day trade patterns and their implications for international trade law.

Keywords: International trade theory, comparative advantage, firm-based trade models, international trade law

Introduction

Trade refers to the exchange of goods and services for money. Within a country, these exchanges take place between domestic buyers and sellers and are known as domestic trade. When the exchange occurs between buyers and sellers located in different countries, it is referred to as international trade. The basic reason nations engage in trade is straightforward. No country is able to produce everything it needs in sufficient quantity or quality. A country may have rich natural resources yet lack certain essential items, such as fish or meat. Another may be highly efficient in producing milk but face shortages of wheat or rice. In such situations, countries rely on one another to obtain what they cannot make themselves. International trade, therefore, arises from differences in resource availability, production abilities, and national needs.[1]

While differences in natural resources or production capabilities help explain why countries trade, this is only part of the picture. Nations also trade to benefit from specialised skills, technological advantages, cost efficiencies, scale economies, and evolving consumer preferences. Classical and neoclassical theories focused mainly on resource endowments and relative factor advantages to explain trade patterns. Modern approaches, however, show that trade can occur even between similar countries, driven by innovation, increasing returns to scale, and product differentiation. Taken together, these perspectives show that international trade is shaped not only by what countries have, but also by how they produce, innovate, and compete in a global market.

Against this background, studying classical and modern trade theories becomes essential for understanding how these different forces operate. Classical and neoclassical theories offer the foundational explanations based on labour, productivity, and factor endowments, while modern theories expand the analysis to include technology, scale, strategic behaviour, and market structure. Looking at both sets of theories together helps clarify not only why trade first emerged, but also how contemporary trade patterns have evolved. This paper examines these theoretical approaches in detail to show how each contributes to a fuller understanding of international trade.

[1] Dr. Pankaj Kumar Sharma, *International Business and Trade: Unit-2* (DSPMU, undated), https://dspmuranchi.ac.in/pdf/Blog/INTERNATIONAL%20BUSINESS%20AND%20TRADE%20UNIT2.pdf (accessed Nov. 28, 2025).

Theories of International Trade

Economists have developed various theories over time to explain why countries trade and how trade patterns evolve. The earliest explanations fall under the classical tradition, where the nation itself is treated as the primary actor in international exchange. These theories emphasise national endowments, production capabilities, and the idea that countries benefit by specialising according to their absolute and comparative advantages.

By the mid-twentieth century, the landscape of global commerce had shifted. Multinational firms began to play a much larger role in shaping trade flows, investment decisions, and patterns of production across borders. This led economists to develop modern, firm-based theories that look beyond national resources and instead focus on how companies compete. These approaches highlight the importance of innovation, economies of scale, product differentiation, and strategic behaviour in explaining why trade takes place even between countries with similar resources.

Together, the classical and modern perspectives show how the drivers of international trade have expanded from simple resource differences to far more complex interactions between firms, technology, and global markets.

Classical or Country based theories	**Modern or Firm based theories**
• Mercantilism • Absolute Advantage • Comparative Advantage • Heckscher-Ohlin	• Country Similarity • New Trade Theory • Product Life Cycle • Porter's National Competitive Advantage.

Classical and Neoclassical Theory

Classical and neoclassical theories form the foundational framework of international trade analysis. Classical thinkers such as Adam Smith and David Ricardo focused on how production costs and relative efficiency shape trade flows, introducing ideas like absolute and comparative

advantage. Their approach emphasised real economic variables such as labour, productivity, and scarcity, offering the earliest systematic explanation for why nations specialise and exchange goods.

Neoclassical theorists built on this foundation by incorporating more refined assumptions about consumer preferences, factor endowments, and market equilibrium. The Heckscher-Ohlin model, along with later extensions, shifted attention from labour alone to multiple factors of production and their relative abundance across countries. This tradition brought a more formal, mathematical understanding of trade patterns and allowed economists to analyse distributional effects, price changes, and welfare outcomes with greater precision.

Mercantilism (1500-1800)

It was developed in the sixteenth century, and mercantilism represents one of the earliest attempts to explain economic activity. The central idea of this doctrine was that a nation's wealth depended on its accumulation of gold and silver. Mercantilist thinkers argued that the most effective way to increase these holdings was to encourage exports and restrict imports. When a country exported more than it imported, foreign buyers would settle the difference in gold and silver, thereby increasing the exporting nation's wealth. The policy goal, therefore, was to achieve a trade surplus, where the value of exports exceeded the value of imports, and to avoid a trade deficit, which implied the opposite. Mercantilism thus framed international trade as a zero-sum contest in which national prosperity depended on maintaining a favourable balance of trade.[2]

A review of global developments from the sixteenth to the late nineteenth century helps explain why mercantilism took root. The sixteenth century witnessed the rise of new nation-states whose rulers sought to consolidate political authority, expand military power, and build national institutions. Increasing exports became a key strategy for accumulating the gold and silver necessary to support these ambitions. To achieve this, many states imposed restrictions on imports, a practice known as protectionism, which continues to influence contemporary trade policy. Colonial expansion further strengthened mercantilist practices. European powers used their colonies as sources of raw materials and as captive markets for their manufactured

[2] *Id*

goods.[3] The British Empire provides one of the most prominent examples, drawing wealth from territories across the Americas and Asia, including India. France, the Netherlands, Portugal, and Spain similarly built extensive colonial networks that channelled economic gains back to the governing nations.

An example of Mercantilism is that, in 1600, the British government created the 'East India Company', which was a state-sponsored monopoly looking to take advantage of the Asian markets, particularly the East Indian spice trade. Whilst privately owned, it was granted monopoly powers in the market until the British government revoked these in 1813. Since the company's inception and its eventual decline, it paid the government in exchange for sole rights to trade with India. This not only brought gold back to Britain but also helped establish a strong and permanent trade route between Britain and her colonies.[4]

Although mercantilism is one of the earliest trade theories, its influence persists. Modern economies such as Japan, China, Singapore, Taiwan, and Germany have, at various points, adopted neo-mercantilist strategies that prioritise export growth through protectionist measures, import restrictions, and targeted subsidies. In practice, almost every country has used some form of protectionism to shield strategic industries.

Export-oriented industries typically favour protectionist measures that support their competitiveness. However, consumers and other domestic firms often bear the costs. Subsidies require higher public spending, while import restrictions raise prices for foreign goods and limit consumer choice. Advocates of free trade argue that open markets generate broader economic welfare, whereas mercantilist policies disproportionately benefit a narrow set of industries at the expense of the wider economy and the global trading system.

Absolute Advantage (1776)

Over the past two centuries, several theories have been developed to explain the patterns and rationale of international trade. The earliest of these can be traced to Adam Smith, who in 1776 provided the first systematic explanation of why nations engage in trade in his seminal work "An Inquiry into the Nature and Causes of the Wealth of Nations". Smith introduced the theory

[3] 'Mercantilism Theory and Examples', *Economics Help* (Nov. 28, 2025), https://www.economicshelp.org/blog/17553/trade/mercantilism-theory-and-examples/ (accessed Nov. 28, 2025).
[4] *What Is Mercantilism* (compiled by Mohini Gupta, LPCPS), https://e-sarthi.lpcps.org.in/uploads/Notes/4/29/217/Unit%20II/UNIT_2_(1).pdf (accessed Nov. 28, 2025).

of absolute advantage, which argues that a country should specialise in producing goods that it can produce more efficiently than its trading partners, where efficiency is measured in terms of absolute labour costs. His model assumes a single factor of production, namely labour.[5]

Smith observed that if a foreign country can supply a commodity at a lower cost, it is better to purchase that commodity in exchange for goods in which one has an advantage. Trade, therefore, arises when one country has an absolute advantage in producing one good while the other country has an absolute advantage in producing another good.[6] When each country specialises in the good it can produce more efficiently and trades part of its output for the other good, both nations benefit. Specialisation ensures that resources are allocated to their most efficient uses, increasing the total output of both goods. This expansion in combined output represents the gains from specialisation, which trade enables the countries to share.[7] He argued that international trade should not be restricted or shaped by government intervention; instead, it should operate freely according to market forces. When that happens, both sides gain through trade, and living standards rise.

To illustrate, suppose Country A needs 10 labourers to produce one ton of wheat, whereas Country B requires 25 labourers for the same output. In this case, Country A enjoys an absolute advantage in wheat production. Conversely, if Country B can produce one ton of rice with just 5 labourers while Country A needs 20 labourers, then Country B holds an absolute advantage in rice.

What this really means is that, under Adam Smith framework, both countries can gain by specialising in the goods they produce more efficiently. Country A should focus on wheat production and export it, while Country B should specialise in rice and export rice. Through trade, each country can then import the commodity that the other produces at a lower labour cost, leading to mutual gains from exchange.

Comparative Advantage (1817)

Building on Adam Smith's idea of absolute advantage, David Ricardo advanced the analysis

[5] Sharma, *supra* note 4, at 3.
[6] Adam Smith's Theory of Absolute Cost Advantage, *Economics Discussion*, https://www.economicsdiscussion.net/theory-of-absolute-cost/adam-smiths-theory-of-absolute-cost-advantage-economics/30675 (accessed Nov. 28, 2025).
[7] Unit-4, *IGNOU eGyanKosh* (2022), https://egyankosh.ac.in/handle/123456789/90602 (accessed Nov. 28, 2025).

of international trade in his 1817 work, "*Principles of Political Economy and Taxation"*. In this text, he introduced the law of comparative advantage, a principle that remains one of the most influential and enduring concepts in economics. Ricardo demonstrated that trade can be mutually beneficial even when one country possesses an absolute advantage in the production of all goods, and the other has no absolute advantage in any good. What matters is not absolute efficiency, but relative efficiency.[8]

Ricardo argued that a nation, like an individual, gains by specialising in the goods for which it has the greatest comparative advantage and importing those for which it has the least. In practical terms, a country should specialise in producing the goods where its absolute disadvantage is smallest, and import the goods where its absolute disadvantage is largest.[9] This approach ensures that each nation allocates its labour to the activities in which it is relatively more productive, leading to overall gains from trade.

The Ricardian model assumes labour as the sole factor of production, identical and mobile within each country but immobile between them. It also assumes zero transport costs and the absence of trade barriers. Under these conditions, comparative advantage shows why specialisation and trade raise total output and improve welfare in both countries, even when one is absolutely more efficient in producing all goods.

This theory can be understood better from the example cited in Table 1.1.

Consider a simple model with two countries, Country A and Country B, and two goods, wheat and rice. Labour is the sole input used in production. Each country is endowed with a total workforce of 200 labourers. For the sake of simplicity, it is assumed that labour is evenly divided between the two sectors, with 100 labourers engaged in wheat production and the remaining 100 employed in rice production in both countries.

[8] M. A. Rahman, *David Ricardo's Principle of Comparative Cost Advantage Inspires International Trade* (2023), SSRN Scholarly Paper No. 4519038, https://ssrn.com/abstract=4519038 (accessed Nov. 28, 2025).
[9] IGNOU eGyanKosh, *supra* note 7, at 7.

Table 1.1 Production of wheat and rice by Country A and Country B before the trade

	Country A (in tons)	Country B (in tons)
Wheat	20	15
Rice	40	10

Table 1.1 indicates that when 100 labourers are employed, country A can produce 20 units of wheat, while country B produces only 15 units of wheat with the same labour input. Similarly, with 100 labourers, country A produces 40 units of rice, whereas country B produces just 10 units of rice. These figures show that country A is more productive than country B in the production of both commodities and therefore enjoys an absolute advantage in wheat as well as rice.

Although country A allocates an equal number of labourers (100 labourers each) to the production of wheat and rice, the output of rice is significantly higher than that of wheat. This indicates that rice is the commodity in which country A has a comparative advantage. In contrast, country B also uses 100 labourers for each good, but its output of wheat exceeds its rice production. This demonstrates that country B has a comparative advantage in wheat production.

To illustrate this further, suppose country A reallocates its labour force and produces 60 units of rice by employing 150 labourers, while the remaining 50 labourers are used to produce 10 units of wheat. At the same time, country B employs all 200 labourers exclusively in wheat production, resulting in an output of 30 units of wheat and no rice. Under this arrangement, country A exchanges 14 units of rice for 14 units of wheat produced by country B, as shown in Table 1.2.

Table 1.2 Production after specialization

	Country A	Country B
Wheat	10	30
Rice	60	0

Table 1.3 Situation after the trade takes place

	Country A	Country B
Wheat	24	16
Rice	46	14

Table 1.3 clearly indicates that trade yields benefits for both countries. Before trade, country A possessed 20 units of wheat and 40 units of rice. After engaging in trade, its holdings increase to 24 units of wheat and 46 units of rice. This shows that country A is better off in terms of the availability of both goods.

Similarly, country B experiences an improvement in its consumption bundle. Before trade, it had 15 units of wheat and 10 units of rice. Following trade, these quantities rise to 16 units of wheat and 14 units of rice. This outcome demonstrates that both countries benefit from trade based on comparative advantage. What this really means is that international trade can generate mutual gains even when one country holds an absolute advantage in producing all commodities.

In contrast to this view, mercantilist thinkers argued that international trade was a zero-sum activity, where one nation's gain necessarily implied another nation's loss. As a result, they supported extensive government regulation and strict control over economic activities. By

contrast, Adam Smith argued that free trade allows all nations to benefit simultaneously. He strongly supported the principle of laissez-faire, which calls for minimal state intervention in economic affairs. According to this approach, free trade enables the most efficient use of global resources and leads to the maximisation of overall world welfare. However, Smith did acknowledge limited exceptions to this principle, particularly in cases where protection was necessary for industries crucial to national defence.

Heckscher-Ohlin Theory (1933)

Classical economists explained comparative advantage primarily in terms of differences in labour productivity across nations. Still, they offered little insight into why such productivity differences existed, apart from occasional references to variations in climate. The Heckscher–Ohlin theory advances the discussion by extending earlier trade models to identify the underlying sources of comparative advantage and to analyse how trade affects factor incomes in the trading countries. Bertil Ohlin developed what is now known as the theory of international trade, building on the general equilibrium framework introduced by Eli Heckscher. For this reason, the model is commonly referred to as the Heckscher-Ohlin (H-O) theory. It begins where Ricardo's comparative advantage model stops. While Ricardo established that trade is based on relative cost differences, he did not explain why such differences arise.[10] The H-O theory addresses this gap.

According to Ohlin, trade occurs because goods have different relative prices across countries. These price differences stem from variations in relative production costs, which in turn reflect differences in factor prices. Factor prices differ because countries possess different factor endowments. In other words, the pattern of trade is determined by the relative availability of resources within each economy. For this reason, the H-O model is also called the factor endowment theory.[11]

By using a two-factor framework of labour and capital, the theory holds that countries will export goods that intensively use the factor with which they are relatively well endowed and import goods that intensively use the factor in which they are relatively scarce. Thus, labour-

[10] *Id*

[11] S. A. Mansouri, A Brief Review of the Evolution of International Trade Theories and Policies (2022), International Journal of Business and Development Studies, https://ijbds.usb.ac.ir/article_7518_f557ccd5807e7ffe96b2094ecc2a8155.pdf (accessed Nov. 28, 2025).

abundant countries specialise in labour-intensive products, while capital-rich countries specialise in capital-intensive goods.

The Heckscher-Ohlin theory rests on a set of simplifying assumptions that form the basis of its modern approach to international trade. The model typically assumes two countries, A and B; two factors of production, labour and capital; and two goods, X and Y, where X is labour-intensive, and Y is capital-intensive. Country A is assumed to be relatively abundant in labour, while Country B is relatively abundant in capital. Markets for both goods and factors operate under perfect competition. Production functions exhibit constant returns to scale, transport costs and trade barriers are absent, and demand conditions are identical in both countries.

These assumptions help isolate the core idea behind the theory: differences in relative factor endowments lead to differences in relative factor prices, which in turn generate differences in relative commodity prices. On this basis, Ohlin argued that a country will export goods that use a higher proportion of the factor it possesses in relative abundance, since that factor will also be relatively cheaper. Conversely, the country will import goods that use intensively the factor that is relatively scarce. Trade thus arises because differences in factor endowments translate into comparative advantages.[12]

In the two-country, two-commodity, two-factor framework, the model predicts that the capital-rich country will specialise in and export capital-intensive goods, while the labour-abundant country will specialise in and export labour-intensive goods. The notion of factor abundance, however, can be defined in two ways. Ohlin's approach uses factor prices: a country is labour-abundant if labour is relatively cheaper than capital compared with another country. Alternatively, factor abundance may be defined in physical terms by comparing the actual quantities of capital and labour.[13] Both definitions aim to capture the underlying idea that relative resource availability shapes a nation's trade pattern.

Leontief Paradox

The Leontief Paradox emerged in the early 1950s when Wassily W Leontief, a Russian-born

[12] Edward E. Leamer, *The Heckscher–Ohlin Model in Theory and Practice* (Princeton Studies in Int'l Fin., No. 77, Int'l Fin. Section, Dep't of Econ., Princeton Univ. 1995), https://ies.princeton.edu/pdf/S77.pdf (accessed Nov. 28, 2025).
[13] W. M. Corden, The Theory of International Trade, in *Economic Analysis and Multinational Enterprise* 27 (1st ed. 1974).

American economist, tested the predictions of the Heckscher-Ohlin factor proportions theory using empirical data from the United States. According to the theory, the United States, being a capital-abundant country, should have specialised in and exported capital-intensive goods, while importing labour-intensive goods. Leontief's findings, however, revealed the opposite. His analysis showed that the United States was exporting goods that were relatively labour-intensive and importing goods that were more capital-intensive. This unexpected outcome came to be known as the Leontief Paradox.[14]

Subsequent research suggested that, during that period, the United States had a labour force that was not only sufficient in supply but also significantly more productive than labour in many other countries. Higher productivity made labour-intensive exports rational despite the country's overall capital abundance. Over time, economists have offered various explanations to reconcile the paradox, using new data, alternative models, and broader definitions of factor endowments. The broader implication of the Leontief Paradox is that international trade is shaped by multiple and dynamic forces. No single theory can fully capture the complexity of trade patterns, and the evolution of empirical evidence continues to refine the way economists understand the determinants of global trade.

Criticism of Classical and Neoclassical Theories

1. Unrealistic Assumptions about Factors and Technology

Classical and neoclassical trade theories rest on highly simplified factor assumptions and treat technology as essentially fixed. Classical models rely almost entirely on labour as the sole input, while neoclassical frameworks add capital but still ignore critical modern drivers such as human capital, research and development, innovation and entrepreneurial capability. These omissions make the models less persuasive when applied to contemporary global production systems.[15]

2. Perfect Competition and Homogeneous Products

Both theories assume perfectly competitive markets composed of many small firms producing identical and undifferentiated products. This abstraction does not reflect the structure of

[14] Christina Paraskevopoulou, *Revisiting Leontief's Paradox*, 30 *Int'l Rev. Applied Econ.* 693 (2016).
[15] Paul Krugman, *Rethinking International Trade* (MIT Press 1990).

modern industries, which are dominated by large firms with market power, product differentiation, strong branding, advertising strategies and complex competitive behaviour. As a result, these theories fail to capture the realities of today's industrial organisation and global value chains.[16]

3. Ignoring Economies of Scale and Increasing Returns

Classical and neoclassical models assume constant returns to scale and give no central role to increasing returns. In reality, many industries reduce costs through large-scale production, and these scale economies strongly influence trade patterns and industrial concentration. Their omission limits the theories' relevance to modern manufacturing and technology sectors.

4. Costless Trade Assumptions

These theories assume the absence of transport costs, tariffs, quotas, or other trade barriers. Since real-world trade is shaped heavily by logistics, distance, customs procedures, and government policy, the assumption of frictionless trade makes the models unrealistic and limits their explanatory power.

5. Poor Explanation of Intra-Industry Trade

Classical and neoclassical theories predict trade between industries, not within the same industry. They cannot explain why similar countries export and import similar varieties of goods, a pattern widely observed among advanced economies. This limitation reduces the usefulness of these theories in understanding modern trade dominated by differentiated products and global value chains.

6. Focus on Countries Rather Than Firms

Both theories focus on countries as the unit of analysis, overlooking firm-level differences. Modern trade is driven by multinational corporations, global value chains, branding strategies, technology ownership, and productivity variation across firms. By ignoring these micro-level forces, classical and neoclassical theories miss how trade actually takes place today.

[16]Stephen Hymer, The Multinational Corporation and the Law of Uneven Development, in *Explaining International Production* (John H. Dunning ed., Unwin Hyman 1988).

Modern or Firm-Based Theories

Modern theories of international trade emerged in the post Second World War period because earlier country-based models could no longer explain how global trade actually operated. Classical theories treated nations as the key actors and assumed that countries specialised only in producing the goods in which they had a comparative advantage. After the war, however, multinational enterprises expanded rapidly and began operating across several jurisdictions. Their growth reshaped global trade by shifting the focus from countries to firms.[17]

As a result, trade patterns changed. Nations were no longer exchanging only different types of goods; they were increasingly trading similar products within the same industry. This phenomenon of intra-industry trade could not be accounted for by classical or neoclassical models, which relied on national factor endowments rather than firm-level choices. Modern theories address this gap by explaining trade through the strategies, market power and innovative capacities of individual firms instead of national characteristics alone.

Country Similarity Theory (1961)

Classical trade theories struggled to explain a key real-world pattern: wealthy countries often import and export the same kinds of products. These theories assumed that nations trade based on cost advantages and factor endowments, but they could not account for the growing volumes of intra-industry trade among advanced economies.

Burenstam Linder approached the problem from the demand side, not the supply side. He argued that consumers in countries with similar income levels tend to share similar tastes, quality expectations, brand preferences and standards of design or technology.[18] Firms, in turn, produce goods that match these domestic preferences. The set of tastes and expectations that shape what firms produce is what Linder called the domestic demand structure of a country. Once firms become successful in their home markets by meeting domestic tastes, they naturally seek foreign markets where consumers look similar to their own.[19] As a result, firms in high-income countries tend to export mainly to other high-income countries, because these markets

[17] Maria Savona, *Why the Firm Matters in the Global Economy*, LSE Bus. Rev. (Nov. 28, 2016), http://blogs.lse.ac.uk/businessreview/2016/11/28/why-the-firm-matters-in-the-global-economy/ (accessed Nov. 30, 2025).
[18] IGNOU eGyanKosh, *supra* note 7, at 7.
[19] Mohini Gupta, *Unit I – Trade* (teaching material, Dep't of Commerce & Mgmt., LPCPS, undated), https://e-sarthi.lpcps.org.in/uploads/Notes/3/24/173/Unit%20I/UNIT_1.pdf (accessed Nov. 30, 2025).

show the strongest overlap in demand. Trade is therefore driven not by differences in resources, but by similarities in consumer preferences.

The theory helps explain trade in industries where subjective qualities such as brand reputation, design, style, reliability and technological sophistication matter more than simple production costs. In such sectors, firms compete through product differentiation and quality, and countries with comparable income levels trade extensively with one another. Linder's contribution shifted the focus from what countries can produce cheaply to what consumers in similar economies actually want, making it one of the earliest modern explanations for intra-industry trade.[20]

Product Life Cycle theory - Raymond Vernon 1966

The International Product Life Cycle Theory, developed by Raymond Vernon in the 1960s, explains how new manufactured products move through distinct stages and how their production locations shift across countries as they mature. In the new product stage, innovation and early production take place in the innovating country, where income levels, R&D capacity and consumer awareness are high. As demand grows, the product enters the maturing stage, production techniques stabilise, and firms begin exporting to other advanced economies with similar consumer profiles. Eventually, in the standardised product stage, the product becomes routine, cost-driven and mass-produced, encouraging firms to shift production to lower-cost developing countries. At this point, the innovating country may even start importing the very product it once exported, illustrating how comparative advantage changes over time.[21] The theory was path-breaking because it showed that trade patterns evolve with the life cycle of the product, not just with static factor endowments. However, its assumptions no longer fully match present global realities. Innovation is now dispersed across multiple countries, including emerging economies; global value chains distribute production tasks across borders from the very beginning; and many products never stabilise into a fully standardised form because continuous upgrades and niche differentiation keep them in a prolonged growth phase. Although the theory still helps explain shifts in production and outsourcing, it requires

[20] Tri-Dung Lam, *A Review of Modern International Trade Theories*, 1 *Am. J. Econ., Fin. & Mgmt.* 604 (2015), https://aurak.ac.ae/publications/A-Review-of-Modern-International-Trade-Theories.pdf (accessed Nov. 28, 2025).
[21] Raymond Vernon, *International Investment and International Trade in the Product Cycle*, 80 *Q.J. Econ.* 190 (1966).

adaptation to reflect today's rapid technological diffusion and globally integrated manufacturing systems.

New Trade Theory by Paul Krugman (1979)

The New Trade Theory emerged to explain trade patterns that older models could not, especially the rise of intra-industry trade among countries with similar income levels. Unlike classical or neoclassical theories, which relied on differences in technology or factor endowments, the New Trade Theory showed that trade can arise even when countries are identical in resources and productivity.

This approach is built on three central ideas: economies of scale, product differentiation, and imperfect competition. First, the New Trade Theory highlights the role of internal economies of scale. As a firm increases its own output, its average costs decline. Larger production runs, or long series, make goods cheaper to produce. When countries engage in trade, firms gain access to bigger markets, expand output, and enjoy lower costs. This means that scale economies alone can generate trade, even without differences between countries.[22] Second, the theory assumes that goods are differentiated, not identical. Each firm produces a unique variety of a product, creating brand-level distinctions in design, features, and style. Consumers value this diversity and experience higher utility when they have access to multiple varieties. Because countries specialise in producing only some varieties and import the rest, this naturally produces intra-industry trade.[23] Third, Krugman models markets using monopolistic competition, where numerous firms sell differentiated products. Each firm enjoys some market power due to its unique variety, but free entry into the market keeps long-run profits close to zero. Under these conditions, opening to trade increases the number of varieties available to consumers while lowering prices through scale economies. Rather than low profits when sticking to the domestic market, the firms expand their markets by entering into trade. This captures real-world patterns where advanced economies import and export similar differentiated goods.[24]

[22] Paul R. Krugman, Maurice Obstfeld & Marc J. Melitz, *International Economics: Theory and Policy* (10th ed. Pearson 2015).
[23] Asad Alam, *The New Trade Theory and Its Relevance for Developing Countries* (Policy Research Working Paper No. 1274, World Bank Afr. Reg'l Office, Mar. 1994)
[24]https://documents1.worldbank.org/curated/en/205941468764425699/pdf/multi0page.pdf (accessed Nov. 30, 2025).

Together, these elements explain why modern trade is driven not only by comparative advantage but also by firm behaviour, economies of scale, and consumer preference for variety. New Trade Theory, therefore, provides a more realistic account of today's trade flows, especially among high-income economies.

The Global Strategic Rivalry Theory (1980s)

Global Strategic Rivalry Theory was developed in the 1980s, drawing on the work of economists Paul Krugman and Kelvin Lancaster. The earlier, country-based trade theories treated international trade as a natural outcome of resource differences between nations, but this approach could not explain how competition actually unfolded in modern global markets. Strategic Rivalry Theory argues that trade patterns are shaped less by national comparative advantage and more by the actions of large multinational firms competing for long-term market dominance. According to this view, firms invest heavily in research and development, intellectual property protection, product innovation and large-scale production to create barriers that deter new entrants. These barriers are not necessarily anti-competitive; rather, they reflect deliberate strategies that strengthen a firm's capabilities to the point where potential competitors struggle to match their cost structures, technology, or accumulated expertise. In this way, international trade becomes the outcome of firm-level rivalry rather than national characteristics.

Porter's National Competitive Advantage Theory (1990)

Porter argued that modern international competitiveness depends less on natural endowments and more on a country's ability to create, upgrade, and sustain advantages through innovation. His Diamond Framework explains why some nations excel in particular industries by highlighting four interconnected determinants.

The first is factor conditions. Porter separated factors into basic and advanced categories. Basic factors include natural resources, unskilled labour, and climate. Advanced factors include skilled labour, technological capability, research institutions, and modern infrastructure. While basic factors may help in the short term, Porter maintained that advanced factors drive long-term competitive advantage because they arise from continuous investment, learning, and innovation.[25] Countries that consistently build their knowledge and technological base tend to

[25] Sivanathan Sivaruban, *Theories of International Trade* (Int'l Training Inst., May 31, 2024), https://ssrn.com/abstract=4850009 (accessed Dec. 1, 2025).

perform strongly in high-value sectors.

The second determinant is demand conditions. A large and sophisticated home market pushes firms to improve product quality, adopt new technologies, and innovate rapidly. When domestic consumers are demanding, firms develop capabilities early and gain an advantage when they enter global markets because they are already accustomed to meeting high expectations.

The third determinant relates to the strength of related and supporting industries. When firms operate within competitive industrial clusters, they benefit from efficient suppliers, complementary industries, and ongoing knowledge spillovers. This environment reduces costs, supports rapid innovation, and encourages collaborative development, reinforcing the competitiveness of the entire cluster.

The fourth determinant concerns firm strategy, structure, and rivalry. National conditions influence how firms are organised, how they operate, and how they compete. Porter viewed strong domestic rivalry as a key driver of global competitiveness. Competitive pressure at home compels firms to innovate, become efficient, and pursue long-term investments to stay ahead. Porter also recognised the role of government. Through policies, regulations, and targeted support, governments can enhance the competitiveness of firms and, in some cases, entire industries.[26]

Overall, Porter shifted the focus of international trade theory from static factor endowments to dynamic processes built on innovation, learning, and continuous upgrading. His framework helps explain why certain countries dominate advanced manufacturing, technology, design, and modern services.

Dominant Trade Theory

No single trade theory can be identified as universally dominant in the contemporary global economy. Each theory captures a different aspect of trade behaviour, and modern patterns often reflect a blend of these ideas rather than the exclusive operation of any one framework. Classical theories, such as absolute and comparative advantage, continue to provide the basic foundation by explaining why countries gain from specialisation. Yet the assumptions

[26] *Id*

underlying these theories, particularly the idea that factors of production are immobile or evenly distributed, do not always align with present-day conditions.

In practice, much of global trade today is better understood through frameworks that incorporate scale, innovation, and firm-level dynamics. New Trade Theory has gained particular relevance as it explains how increasing returns to scale, product differentiation, and the dominance of large multinational firms shape trade flows. This aligns with the reality that a significant share of world trade occurs within global value chains operated by a small number of powerful firms.

Porter's Diamond Framework has also become influential because it recognises that competitive advantage is not inherited but created. Its emphasis on advanced factors such as skills, technology, innovation systems, and sophisticated domestic demand reflects how countries like the United States, Germany, Japan, and South Korea sustain leadership in high-value industries. The model captures the shift from resource-driven to innovation-driven competitiveness, a trend that defines much of twenty-first-century trade.

At the same time, elements of the Heckscher-Ohlin approach remain visible in labour-intensive manufacturing economies, particularly in Asia, where abundant labour and lower production costs continue to shape comparative advantages. These patterns show that traditional factor-endowment explanations still apply, but only partially.

Overall, modern trade is best explained by a layered combination of theories. Scale economies, technological capability, industrial clusters, global production networks, and firm strategies now play a central role, making New Trade Theory and innovation-based models the most reflective of current realities. Instead of one dominant theory, contemporary trade operates at the intersection of classical principles and modern insights that account for complexity, integration, and continuous structural change.

Conclusion

The different international trade theory comprehensively outlines the historical evolution and diversity of thought in understanding global trade dynamics. Beginning with classical theories such as Mercantilism, Absolute Advantage, and Comparative Advantage, it establishes the foundational idea that countries benefit from specialisation based on resource endowments and

productivity differences. However, these classical models, while insightful, rely on assumptions of perfect competition, immobile factors, and homogenous products, which limit their applicability to the complexities of modern trade.

Transitioning to neoclassical and modern firm-based theories, it highlights how economies of scale, product differentiation, and multinational enterprise strategies shape trade patterns beyond simple factor endowment explanations. Modern approaches like New Trade Theory, Porter's Diamond Framework, and Strategic Rivalry Theory reflect the realities of innovation-driven competitiveness, intra-industry trade, and global value chains. These frameworks provide a more advanced understanding of why similar countries trade similar products and how firms influence international commerce through technology, branding, and strategic investment.

It can be understood that no single theory dominates contemporary international trade explanations; rather, a synthesis of classical principles and modern insights is necessary to grasp the multilayered nature of global trade. This plurality highlights the challenges policymakers and legal institutions face in designing trade rules and resolving disputes amid differing theoretical perspectives.

Overall, the paper synthesises the progression from resource-based to innovation and firm-centric models, reflecting the dynamic nature of international trade. This comprehensive analysis provides a valuable foundation for understanding the complexity of international trade in an increasingly interconnected and technologically sophisticated global economy.

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