Examples regarding the theory of comparative advantage economics essay

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The famous economist David Ricardo introduced the theory of comparative advantage. Comparative advantage is where an economy would benefit in the production of a good/service where it has a lower opportunity cost compared to its trading partners. Whereas, free trade is the exchange of goods/services between economies which makes countries dependent on each other.

The research has been carried out by examining the principle of comparative advantage, whether the countries benefit from comparative advantage or not, alternative theories such as Heckscher-Ohlin model and Stolper-Samulson theory, how economies benefit from free trade, what would happen if an economy was closed to trade, protectionism, trade liberalisation and with the help of trade statistics adapted from WTO (world trade organisation), IMF (International monetary fund), OECD and ONS (Office of national statistics). All the data and research are from last ten years.

A lot of economists are in favour of free trade and comparative advantage. Research has suggested that both developed and developing countries have benefited from free trade due to various reasons and comparative advantage being one of them. The study also shows that due to trade liberalisation and many other reasons trade has increased over the years. Form the findings overall it could be said that benefits outweigh the drawbacks.

International trade is the exchange of good and services between economies. It is known that trade takes place mainly because of specialisation and economies of scale both are principles of comparative advantage. (Journeyman TV, 2006)

(Miles, David)(2005) Says that ' comparative advantage means that all countries benefit from free trade even if they are characterized by low levels of productivity. Underlying this result is the concept of opportunity cost, which means that countries have a comparative advantage in industries that they are relatively or comparatively best at.' This suggests that countries benefit from comparative advantage even if countries are less productive than its trading partners as long as they have an opportunity cost. Therefore, countries should produce goods in which they specialise and have a relative cost considering that it only gives up fewer resources. Opportunity cost is the forgone opportunity to produce another good. Hence, giving up something to produce another good. This means the lower the opportunity cost, the more a country will benefit. This can be seen in the example further on. Therefore, in order for a country to benefit, it must produce goods at lower opportunity cost giving up fewer resources.

A country specializes in products for which it has a comparative advantage instead of producing everything itself and exports the surplus of the specialized goods in exchange for imports from the partner countries. (Dunkley)(2005)

If a country has a disadvantage of producing a product with respect to another country, the disadvantaged country can still benefit from free trade even if they are less productive in every industry in comparison to other nations. If a country is to have a comparative advantage in producing a product, it must be able to produce that particular product at a lower opportunity cost in relation with another country. For example:

	USA	UK
Jeans (per day)	20	12
Cars (per day)	30	12

As shown on the above table USA is surely producing more units of jeans and cars than UK. In terms of comparative advantage however, UK is more productive in producing jeans in comparison to USA. This is because the opportunity cost of producing 1 pair of jeans in UK is only 1 car while for USA it is 2 cars. Therefore, it would be more cost efficient if the USA manufactured the cars and exported the cars to UK while the UK produced jeans and exported to USA.

Limitations of the Ricardian model:

Gregory P (week 5) ‘ Ricardo’s model is more static than dynamic’. This means that the time period is ignored. Comparative advantage does not remain static they can change in the long run, due to technology variations and change in competence level. Dynamic efficiency is when ‘ a firm will have a unit cost advantage because of the experience it acquires through cumulative production of goods and services’ Nello (2009). Reduction in

costs may be due to technological improvements, better organizational structure or quality of work.

Both theories, Michalek (n. d) ‘ Ricardo and Adam Smiths theory assumes perfect competition and perfect knowledge’. However, in reality multinationals and oligopolies exists and economies have protectionist policies. The theory ignores transport costs and assumes constant returns to scale. In reality transport costs do exist however it varies geographically. For example, transport costs within the EU would be cheaper than because of the de-fragmented market. However, costs would be higher if countries were exporting goods from one continent to another. Thirdly, no trade barriers are assumed between countries and two countries and two commodities. Therefore, what would have been better was to have known the effect if any trade barriers or protectionist policies were in place. More on tariff and protectionism is explained later in the essay.

Adam Smiths theory of trade is based on absolute advantage. The theory is based on specialisation, this means a firms workers are doing a repetitive task. This saves time as workers are doing the same job, which will increase efficiency and the total output. Increase in efficiency will be achieved through economies of scale. Economies of scale generate increased returns due to declining units of production costs and as a result the output rises. The diagram below can be used to explain how trade can benefit from economies of scale.

Static economies of scale graph.

Assuming UK and USA are identical. Point ‘ A’ will be the equilibrium point before the 2 countries start to trade. ‘ A’ will be used for both the countries assuming identical.

At point ‘ A’ UK and USA can consume and produce 20 units of product X and product Y. If a country were to specialize, for example, say UK wants to increase in production of X, relatively product Y would fall. To specialize, UK would have to move along the curve till it reaches the specialization point at B. Vice versa for product Y at B’ for USA.

When trading takes place:

UK can export 30 units of X for 30 units of Y from USA. Hence moving to point ‘ E’. Similarly USA can export 30 Y units for 30 X units from UK, which leads to both countries moving to ‘ E’. As a result both countries gain from economies of scale as both UK and USA gain 10 X units and 10 Y units, therefore reducing costs and increasing production.

Product differentiation

One of the benefits from trade is that it encourages competition. Product differentiation is when a product is produced in the same industry but are differentiated. Hence this gives rise to an additional benefit from trade and also makes products more attractive since customers have a wider choice of products that suit their needs. Therefore in international trade, the small countries benefit more as they have a wider choice. For example, France and Germany import and export cars of different models even though they are in the same industry. (Deardoff, 1998)

Arguments against free trade

Increased disruption and increased unemployment

Increased unemployment is created by unions supporting low skilled labour jobs, which are exported abroad leaving domestic workers unemployed. Wage inequalities are increasing due to removal of trade barriers. For example, the prices of textile goods fall in developed countries whereas prices of manufacturing products increase due to greater demand. Lower prices on imports put downward pressure on wages paid to low skilled workers and higher prices on exports put upward pressure on high skilled workers. This has led to wide increase in wage inequality in developed countries. The inequality exists because of technological advances. However, overall economic welfare has been increased of a country.

Secondly, more and better capital needs to be employed. Increase in capital per worker at the same rate of increase in labour is needed. This is known as capital widening. This will increase investment through the use of capital, which is beneficial to the economy in the long run. Theory suggests that a country should export goods in which it is better at producing and import those goods in which other countries have absolute advantage. This means the number of units of output a worker can produce in one hour or in other words the number of hours it takes to produce one unit. (Barry University, 2009)

Even though practice makes workers perfect, it can lead to boredom. This means that there could be a decrease in marginal productivity and diseconomies of scale. The impact will be greater if an economy was closed

to trade. This due to a country producing more than one good, it will not be efficient in producing all the goods. Therefore, costs will be higher because of inefficiency leading to diseconomies of scale. This reduces overall standard of living or economic welfare of a country. This can be explained in the graph below.

Graph-diseconomies of scale.

Protectionism.

Protectionism is when the government protects its domestic producers from competing with foreign producers. This is normally achieved by import quotas, tariffs or embargoes.

Figure shows that what happens in the absence of tariff. Powell (2005)

In a domestic market, equilibrium will be at point X. At point X, consumers pay price P for the good whereas the quantity produced and sold at point Q. Consumers benefit from the given price, therefore consumer surplus/welfare is area a, PXZ. Producer surplus/welfare is area b+d, XPU. Nello (2009) Consumer surplus is the difference between the price that a consumer is prepared to pay for a certain quantity of a product and the price that is effectively paid for that quantity. While, producer surplus is the difference between the total revenue and the total cost of the producer and can be considered as the profits of the producer.

Imports are priced at P1, which is lower than P. Therefore the new equilibrium is at point V; domestic demand had increased from Q to Q1 and

domestic supply decreased to Q2. The level of goods imported is between Q1 to Q2. Whereas, the export level is P1Q2.

When trade takes place, consumer surplus increases from B+C points P1VXP but producer surplus fell from b+d to area b, points P1NXP.

Now, if a tariff is imposed on goods the price will increase from Pw to Pd. The price of a good in the importing country increases and falls in the exporting country. At price Pd demand falls from Qd to Q'd and domestic supply increases to Qs to Q's. Therefore, Imports will fall to Q'd to Q's. Consumers lose in the importing country and win in the exporting country. Whereas, producers win in the importing country and lose in the exporting country.

Diagram-tariff imposed Nello (2009)

Consumer surplus will fall by the wedged shaped area PXYZP1 that is the area equal to A+B+C+D. The increase in price raises the producer surplus of domestic firms by the area A and the government gains tariff revenue shown by the area C. The areas A and C are transfers of welfare away from consumers, to domestic producers as well as the government. Therefore, the net welfare gain loss from the tariff is A+B+C+D – [A+B] that is equal to B+D.

In a perfectly competitive market, producers and the government gain from tariff while the consumers are worse off.