Absolute advantage comparative advantage and competitive advantage economics essa...

Absolute advantage theory was first presented by Adam Smith in his book " The Wealth of Nations" in 1776. Smith provided the first concept of a nation's wealth. Adam Smith is a grandfather of economics because he introduced two important concepts that many of the new trade theories are based on these two main concepts, which are specialization and free exchange (Cho et al., 2000). However, many arguments were made and many economists thought there was a problem with the theory of absolute advantage after David Ricardo published the theory of " comparative cost" (aka " comparative advantage") in the early 19th century (Curry, 2000). Even though Smith and his followers introduced many important points for the thoughts of economic, it is too complicated with this simple version of trade theory in today's global economy. In 1990, Michael Porter introduced the diamond model of new competitiveness theory (Cho et al., 2000). These three trade theories are important in order to make a country or business successfully. Therefore, the importance of absolute advantage, comparative advantage, and competitive advantage will be discussed thoroughly.

Absolute advantage is the ability to produce a good with fewer resources than other producers (Ayers et al., 2005). According to Joseph A. Schumpeter (1954, 374), " seems to have believed that under free trade all goods would be produced where their absolute costs in terms of labor are lowest (Van Marrewijk, 2009)." Smith suggests that a country should export those goods and services for which it is more productive than other countries are, and import those goods and services for which other countries have more productive than it is. For instance, assume there are only two countries in the world- France and Japan; there are only two goods – Wine and Clock radios; and there is only one factor of production- Labor. In France, one hour of labor can produce either two bottles of wine or three clock radios. In Japan, one hour of labor can produce either one bottle of wine or five clock radios. Therefore, the absolute advantage to produce wine is France because one hour of labor produces two bottles in France, but Japan only produces one. The absolute advantage to produce clock radios is Japan because one hour of labor produces five clock radios in Japan while France only produces three. France is more efficient in the production of wine and Japan is more efficient in the production of clock radios. If these two countries are able to trade with one another, they both will be better off (Griffin et al., 2010).

Comparative Advantage

The theory of absolute advantage makes sense intuitively. Unfortunately, the theory had a problem. What if one country had an absolute advantage in both products? David Ricardo solved this problem by introducing the theory of comparative advantage, which states that a country should specialize and export those goods and services for which it is relatively more productive than other countries are and import those goods and services for which other countries are relatively more productive than it is (Griffin et al., 2010). Therefore, according to this theory, a country must specialize in order to gain from trade. A country has a comparative advantage if it can produce a good at a lower opportunity cost than could other countries. For instance, Michael Jordan selected basketball as his career and economics as his major. He had to make a choice in order to excel at other majors or careers. He chose basketball where he could shine in with his area of relative strength. On the other hand, Doug might take longer to mow yards than other people would take. Even if he cannot do anything well, he can still do some things relatively better than other things. People would still hire him because he would charge them less than the opportunity cost of their own time. In this case, Michael Jordan might hire him because the opportunity cost of his time would be too high. It would be unrelated that whether Michael could do his own lawn faster (Ayers et al., 2005). Even though the comparative advantage is very useful for explaining the reasons of trade and the increases welfare of the trading partners by trade, this theory is still incomplete. There are two problems in this theory. First, the extreme degree of specialization can be predicted by this theory, but in some countries, they not only produce one good but many import-competing products. Second, the trade based on differences in country productivity levels between countries, but it did not explain the existence of these differences (Cho et al., 2000).

Competitive Advantage

The leading theorist of competitive advantage theory is Michael E. Porter. According to Porter, " National prosperity is created, not inherited". It grows with natural endowments in a country, as well as its labor pool, its interest rates, or its currency's value. The competitive advantage of nations is the capacity of its industry to innovate and upgrade to form a nation's competitiveness. Companies benefit from having home based suppliers aggressively, domestic rivals strongly, and demanding local customers. Geographic cluster or companies concentrations established competitive advantage in different parts of the same industry. According to Porter, nations are most likely to succeed in industries where the national ' diamond' is the most favorable. He believes that success in international trade comes from the four interrelated components, which are factor conditions, demand conditions, related and supporting industries, and firm strategy structure, and rivalry. Porter also concluded that their home environment is the most forward-looking, challenging, and dynamic so that nations succeed in particular industries (Cho et al., 2000).

Companies achieve competitive advantage from acts of innovation. They approach innovation in both new technologies and new ways of doing things. Innovation can be represented in a new product design, new production process, or a new marketing strategy. Perceiving an entirely new market opportunity can contribute to create competitive advantage from some innovations. Innovation yields competitive advantage when competitors are slow to respond. For instance, in autos and home electronics industries, Japanese companies focused on smaller and lower capacity models that foreign competitors despised as low profit, low importance, and low attraction (Cho et al., 2000).

Conclusion

The three traditional trade theories were discussed. They are all useful theories that remain in understanding many of industrial and trade policies nowadays. For example, when a country considers industrial and trade policies, the comparative advantage theory can be a basic guideline. Because today's world is much more complicated than before, those theories are not satisfactory in explaining the international trade in nowadays situation. The main goal of model building is understand the world easily by recognize the most important variable or variables (Cho et al., 2000).