Free research paper on international economics part 1

Economics, Trade

1. Explain the concept of comparative advantage and the principle theories of why trade occurs.

Comparative Advantage can be defined as the ability of a country to produce goods and to deliver services at a cost below that of the competitors. The concept was developed by David Ricardo in the attempt to amend the principle of absolute advantage presented by Adam Smith in his book The Wealth of Nations. According to Smith trade develops between countries that have absolute advantage in producing a certain product or service, or, in other words, that are able to use less resources for production than their rivals. Ricardo, however, emphasized that it is not only the absolute cost differences that create profitable opportunities for trade but also relative advantages. This theory came to be known as the Theory of Comparative Advantage. It helped to understand the emergence of trade even between countries that have no absolute disadvantage. According to Ricardo’s theory countries should specialize and export in the product that they are less inefficient in, while countries with absolute advantage should focus on those goods and services that they are most efficient in. Hence, it is the relative costs that define export/import structure of the countries’ economy (Mankiw, 2012).

The theory of comparative advantage helped to explain trade patterns even among countries that did not possess absolute advantage in any area, but could still benefit from participating in international trade. Moreover, Ricardo’s theory demonstrated that trade is not a “ zero sum game” as the overall production in the economy increases. The gains may arise both from the more efficient use of resources and from specialization and scale. The overall increase in world production leaves all countries better-off even if those that account for only a small percentage of the global trade as they are able to import goods and services at relatively lower prices than that of domestic products. Moreover, local consumers can benefit not only from lower prices but also from a larger variety of goods (Carbaugh, 2011).

2 Analyze and discuss the sources of comparative advantage in national economies.

While Ricardo's theory illustrates the patterns of trade trough the presence of comparative advantage, it does not explain what allows some countries to produce goods and services relatively cheaper than other nations. Economists have presented a number of sources of comparative advantage and suggested some policy implications for countries that want to gain comparative advantage. The first source of comparative advantage is productivity. This point has been used by Ricardo to illustrate his theory, however in the Ricardian model productivity only considers labor. It is possible to extend the notion of productivity by including also the productivity of the factors of production and in particular the level of technology available in the country. The differences in technological development often become key in defining country's productivity and shape the notion of comparative advantage.

Heckscher-Ohlin Theorem suggests that the relative factor endowment also affects comparative advantage. The relative abundance of certain factors of production - labor, land, capital or entrepreneurial ability – define factor endowment. If the country produces goods and services that use relatively more abundant factor it can gain comparative advantage and export these products.

Although factor endowment and productivity explain trade patterns quite well, in some cases they are not sufficient to describe the whole picture and other arguments are used for deeper analysis. Thus, the size of the country may strongly affect its comparative advantage as it allows to gain scale economies in production. Therefore, larger economies will usually specialize in the productions of goods and services that offer higher returns to scale. Local demand will also have effect on the economy, as it offers learning opportunities, demand stability and better customer knowledge. This argument also incorporates domestic intraindustry trade. Among other factors it is also possible to distinguish country’s location, the possibility to import cheap inputs for production and the preferences of international customers, who consider not only the price of certain items but also the quality and the brand image (Carbaugh, 2011).

3. Analyze the international movement of productive factors in order to identify business opportunities and /or threats

International movement of productive factors has a large impact on international business. As factor endowment and productivity affect country’s comparative advantage, the abundance of certain factors of production in a country create an opportunity for businesses to use them to win over international competition. Free movement of these factors could reduce the benefit of country’s endowment and limit business opportunities. Thus, assuming perfect labor mobility, no country will have advantage of lower labor cost as people will migrate to the regions with higher wages. Similarly, investors will invest only in the countries with highest return at the moment. However, these returns will decrease as more investors attempt to buy local shares. International factor mobility also creates threats for businesses that were traditionally shielded by governments and trade barriers. Thus, inefficient industries will lose investors and capital to the more efficient foreign rivals that manage to use these resources more effectively (Salehi-Esfahani).

4. Explain the economic effect of tariffs, nontariff barriers, and various forms of trade policies adopted by national governments.

Governmental policies may significantly change the competitive landscape by increasing or decreasing countries' comparative advantage. One of the most common tools to alter competitive strength of the company are trade barriers that can be either nontariff or in the form of tariffs. Tariffs take the form of a fee that foreign producers have to pay to sell their product/service in a certain country. The effect of imposing a tariff can be illustrated by Figure 1.

The introduction of a tariff leads to an increase in price for the product above the world price, thus reducing demand and foreign supply to Qd2 and Qs2 respectively. This fact favors local producers giving them a chance to gain comparative advantage over foreign rivals. The area of the deadweight loss indicates that tariffs lead to suboptimal allocation of resources, which decreases the overall world production. Nontariff barriers, such as quotas and subsidies, have a similar effect for the economy. They limit foreign supply and lower the cost of local producers in order to make them more competitive. The industry that is supported through tariff or non-tariff barriers gains a comparative advantage over foreign rivals. Therefore, the design of trade barriers helps governments to shape both domestic economy and trade (Boyes & Melvin, 2011).

Other policies could be also introduced in order to impact country's comparative advantage. Thus, heavy investment in education could increase country's supply of skilled labor that can be used to enhance the development of knowledge-intensive industries. In the majority of cases governmental policies are introduced only temporarily in order to support local producers or to help the country take a certain strategic direction. However, it often happens that governmental support becomes counterproductive and local industries never manage to become independent and to compete fairly in the international market (Mankiw, 2012).

References

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