When we do this, it becomes a

When we do this, it becomes a case of absolute cost differences (expressed in money terms rather than in labour units). By comparing the money cost of a good in the two countries, we can at once conclude that the country with the lower money cost would be exporting the said good.

Comparing Money Prices:

It would be noted that we can reach the same result in a much simpler manner. Remembering that in competitive markets, the money cost of production of a good is equivalent to its price, we can straightaway compare the market price of a good (in monetary units) in the two countries and see which country would export it.

Wage Rates Affect Comparative Advantage:

It is also obvious that any change in the ratio of wage rates in the two countries will also result in a change in the position of their comparative advantage.

A country loses its cost advantage to the extent its wage rate goes up. And there can be a complete loss of cost advantage if the increase in wage rate is sufficiently high. (ii) More Than Two Countries: The basic principle that a country will tend to specialise in the production of that good in which it has a most advantage holds in this case also. For each individual item, production begins with the country having maximum cost advantage. The extent of specialisation would depend upon (a) its production capacity, (b) the continuation of cost advantage (which tends to get neutralised in case of increasing costs), and (c) the demand for the said good both in the domestic market and importing countries, by the consumers at its alternative prices. If

this country is not able to meet the entire demand of the said good, its production would be supplemented by the country which has the next maximum cost advantage. And so on.

(iii) Introduction of Money Wages: Introduction of money wages brings greater clarity to the classical trade theory. In this context, two basic points should be taken note of:

(a) Money Prices to Guide the Decision-makers:

Assuming that trading economies have competitive domestic markets, pre-trade price of a good would be equal to its money cost of production (labour cost multiplied by wage rate). The sellers and buyers of each good would just compare its money price in different countries and decide where to sell it or from which country to buy it. That way, when sellers and buyers are faced with absolute money prices, the case of comparative cost differences also becomes one of absolute cost differences. International price of each good is determined by an interaction between its demand and supply forces, and this price, in turn, acts as a guide to producers, exporters, importers and buyers in their decisions.

(b) Range of Wage differences:

The lower-cost country can pay higher wages and still be in trade, but only within labour-cost ratios of the products. Let us, for the sake of simplicity, consider our model of " two-goods two- countries" in which Country I has a cost advantage in the production of both goods. (iv) Transport and Other Trading Costs: Introduction of transport, insurance and other trading costs does not alter the basic reasoning or conclusions of the classical theory,

except that they reduce the effective price differences and trade volume. Trading costs can even push some goods out of trade. Also, if the traded goods are being produced under diminishing returns to scale (increasing opportunity costs), an expansion in trade reduces the cost advantage at the margin and eventually wipes it out.

Consequently, volume of trade under diminishing returns to scale is smaller than it is under constant returns to scale. However, these costs do not reduce profit margins on all traded items in the same proportion. This is because trading posts are not a fixed proportion of the value of an item. They are determined by several factors like the type of item, the distance between its origin and destination, the risk factor associated with its transition, its weight and so on. Examples can be given of items like software programmes, consultancy services, and the like.

In their case, trading costs are very nominal. (v) Customs Duties: The role of customs duties in restricting trade flow is very similar to that of other trading costs discussed above. Given freedom to trade, customs duties are shared between importers and exporters in the ratio of their demand and supply elasticity’s. However, irrespective of their sharing, they cause a reduction in the volume of trade.