Research paper on concepts of comparative and absolute advantage

Economics, Trade

Theories of International Trade

Comparative advantage is a situation where a firm, country or an individual is able to produce some goods or commodities at a cheaper cost compared to other firms, countries or individuals. The theory of comparative advantage was put across by a UK Economist David Ricardo (1772-1822) and it advocates that a country should only specialize in producing only those goods she can produce cheaper than other countries. It results from the different endowments or factors of production like land, labour, capital, and entrepreneurship skills (Chang, 2002).

The theory of absolute advantage was developed by a Scottish economist Adam Smith and it occurs in the present economic dynamics when a country is able to produce large output compared to other countries using the same amount of resources. The theory advocates for a country to produce goods where it has an absolute advantage. This is because it assumes free trade meaning that as long as goods can move freely from country to country, a country will always get what she can't produce. This theory is normally resented or illustrated with a (2x2) model where by two countries and two commodities are compared. It can also be illustrated in a case where by a country needs less number of days to produce a commodity compared to another (Deardoff, 2005).

In the example above, country A has absolute advantage in producing commodity 1 because it requires less hours compared to country B. country B also has absolute advantage in producing commodity 2 because it requires less time to produce compared to country 1.

Opportunity cost refers to the next best alternative foregone when a choice is made. In other words what you miss in the process of choosing the other. For instance if you buy ice cream, the opportunity cost could be if you put the money in the bank you could have earned interest on it.

If USA decides to produce potatoes the opportunity cost would be;

4/8= 0. 5 units. It will have to forego 0. 5 units of rice for every unit of potato to be produced. If she was to fore go rice, the opportunity cost would be 8/4= 2. 0 units of potatoes for every unit of rice produced.

If Canada decides to produce potatoes, the opportunity cost would be;

16/10= 1. 6 units of rice for every unit of potato produced. If she was to forego rice, the opportunity cost would be 10/16= 0. 625 units of potatoes for every unit of rice produced.

The opportunity cost of potatoes is higher in USA than it is in Canada implying that if it is to be profitable for the two countries, USA can produce e and export to Canada.

Production possibility frontier refers to a curve showing various combinations of amounts of two commodities that could be produced by a given country using the same amount of each of the factors of production. It can also be referred to as the production possibility curve. The PPF curve shows the possible production level maximum of one commodity for any given production level for the other commodity given the same state of technology (Deardoff, 2005).

Trade affects the production possibility frontier in a waythat it encourages countries to specialize in the production of goods where they have comparative advantage which implies that countries will be able to produce goods which they are more efficient in. This will increase the level of output of goods and services which will shift the production possibility frontier outside.

For example, given 10 eggs country A can produce5 cakes or 10 tarts, while with the same Country B can produce 3 cakes and 10 tarts.

In this case, country B will have comparative advantage in producing cakes for it foregoes less cakes for each tart. Therefore country B can specialize in cakes while country A can specialize in tarts which will give them a total of 5 cakes and 10 tarts a result; they gain 1 cake by specialization.

Improvement in technology would result into an outward shift of the production possibility frontier curve if it would benefit both types of commodities. An increase in the work force would result in more factors of production being exploited which would result into an improvement in efficiency and productivity.

A production possibility frontier may also shift in wards due to the decrease in the labour force, low supply of raw materials, natural disasters among others. All these can lead to reduced output which brings an inward shift.

Trade is the exchange of goods and services between and amongst different countries. In the discussion below are the arguments for trade and the arguments against trade;

Trade brings about a greater variety of goods and services available for consumption. Trade if it is international, it brings in a variety of different products from different destinations which gives consumers a wider ray of choice. This will help the different countries to grow and will also improve the quality of life of the citizens (Chang, 2002).

Furthermore, trade leads to efficient allocation and utilization of resources which comes about as countries tend to specialize in goods where they have comparative advantage. When countries specialize on goods where they have comparative advantage, they are able to minimize wastage of resources and duplication is also prevented which also helps to save the environment from harmful gases being linked to the atmosphere.

According to Smith, trade also promotes efficiency in general production as the countries will always try to adopt better methods of production which will reduce the costs of production in order to remain competitive. The countries that areable to produce product at the cheapest price will be able to gain a larger market share. This will help to increase the quality of the product.

However much trade is very important, it also has got some disadvantages or the negative side and in the discussion that follows are some of the arguments against trade. Trade may lead to the importation of harmful products or goods like drugs and cigarettes which may end up ruining the lives of the residents of a given country. For example, some years back China suffered greatly because of the opium they had imported.

Trade could also lead to the exhaustion of resources. This is because due to the high demand and if a country is specializing in the production of a given product. Mostly agricultural products may lead to loss of soil fertility due to over cultivation. This in the end may make the country poor by giving too much burden over the resources.

According to Chang,(2002) starvation could also come up as result of specialization in a way that when a country decides to concentrate on producing only one commodity, in case other countries are not able to produce other commodities either because of natural disasters or wars , all the countries relying on them will starve.

Conclusively, much as trade is of great importance to both developing and developed countries, behind all the goodness also underlies some negative effects, therefore when dealing with trade both sides should be considered.

References

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