Comparative advantage

Does Trade Always Follow Comparative Advantage?

Introduction

Comparative advantage as a justification for free trade has seen a change in status. Until recently, it was the only basis on which economists studied trade. However, changes in the world economy and technology have led to events that make the theory appear weak and irrelevant. This paper shall examine the strengths and weaknesses of comparative advantage.

Fundamental to the theory of free trade based on comparative advantage is that there are intrinsic differences in the countries' resource endowments. While there are numerous strengths of this theory in explaining and helping us understand trade patterns, the prime justification for free trade based on comparative advantage is that it leads to efficient allocation of resources, rising incomes, and improvement in the living standards among all trading partners.

Another strength of the theory is that it allows countries to utilize and exploit their natural wealth and abundant resources. So, countries with long shorelines that are filled with marine life have a comparative advantage in producing sea food while those with mines rich with minerals gain from exporting ores and chemicals.

This theory also helps explain the bulk of the trade that takes place between advanced Western countries and the less developed world. Given the stark differences in the resource structures among the two groups – the West with advanced technology and highly-skilled workers export and the less developed countries with traditional agriculture and cheap unskilled labor – it is easy to understand why the former export sophisticated equipment and capital goods to the latter, who, in turn, export agricultural products and cheap manufactured goods. This kind of trade – involving goods produced by very different industries – is called ' inter-industry trade.'

The past two decades have seen the emergence of new trade theories that have undermined the domination of comparative advantage as the rationale for free trade. In addition, changes in technology and in the economic environment have exposed certain weaknesses in the traditional trade model and given rise to the need for modifications. As a result there are new justifications for free international trade that make the original comparative advantage theory appear rather simple and with limited relevance.

One major weakness of the comparative advantage model is that it cannot explain as to why a rising fraction of world trade is taking place among Western developed nations. Given that such nations (e. g. Western European partners of the EU) have very similar technologies and resource structures, the justification for trade has to be something other than comparative advantage. The bulk of this trade is of the ' intra-industry' variety, i. e. countries export and import similar products. There are factors related to demand and supply that cause intra-industry trade. On the demand side, for example, consumers in the U. S. might wish to buy luxury cars from Europe while buyers in the latter import cheaper cars from the former. On the supply-side, certain kinds of capital-intensive industrial technology is such that as output rises the average costs, and, hence, prices, fall due to economies of scale. As a result, European firms that produce larger quantities of luxury cars like Mercedes have comparatively lower costs and prices making them more attractive to buyers in, say, U. S.

Another trade pattern thatcomparative advantagefails to justify is the growing intra-industry trade that takes place between developed countries and less developed countries. This phenomenon is due to ‘ fragmentation’ of the manufacturing process whereby parts of manufactured items like automobiles that need labour-intensive production or assembly are made in labor-rich countries and exported to capital-rich countries where the product is completed. Even though the trading countries have very different resource structures, unlike in comparative advantage, such trade involves the flow of goods within the same or related industries. A good example of such trade is within NAFTA whereby the more complicated automobile components requiring advanced technology are produced in the U. S and exported to Mexico where the manufacturing of small parts and assembly of the units takes place and the final product is shipped back to the U. S.

There are other reasons for weakness in the theory. The traditional theory of comparative advantage assumes significant differences in countries’ natural endowments and available resource bases. However, new thinking is that government intervention can be used to overcome what might be called natural disadvantages by building comparative advantages in technologically sophisticated economic activities related or unrelated to their natural resource wealth. [2, p. 2, Ch. 1] This means that governments can spend money to import technology and create modern manufacturing ability through investment even though a country did not possess these abilities. As the World Bank suggests, this way a country can acquire comparative advantage. A fine example is how India has managed to acquire a comparative advantage in IT because of huge investments in education and technology. Also, the comparative advantage theory fails to acknowledge transportation costs.

Critics of comparative advantage have focused on some of the undesired outcomes of free trade and on the theoretical shortcomings discussed above.

The central criticism against free trade is that poorer and less developed countries are really at a disadvantage if they export goods in which they have a comparative advantage. Typically, less developed nations with poor education, reliance on traditional agriculture, and lack of modern technology are restricted to the export of agricultural products, minerals, and low-end manufactured goods that require labor-intensive methods of production. Critics say that for such countries poverty is their comparative advantage and that exporting based on comparative advantage does not lead to improvement in living standards and, in fact, causes a growing gap relative to the developed world and prevents them from getting developed.

For one, the demand for the sort of goods that poorer countries is rather limited in the developed world (e. g. food products) and even if they try to export more, it leads to falling prices and therefore lower incomes. Secondly, the low-wage type of manufacturing activity does not result in improvement in technology or knowledge and it only benefits the consumers in the richer countries. The World Bank and others have stated that dependence on low-priced exports only gives rise to low-wage jobs that do not help in raising living standards.

With these issues in mind, critics have strongly rejected free trade based on comparative advantage. As mentioned by the World Bank, countries must try to forge new areas of comparative advantage by focusing on education and knowledge-intensive industries like IT. Clearly the intrinsic comparative advantage that the countries possess is considered detrimental. It is because of this that developing countries are encouraged to establish industrial zones by investment in advanced technology and manufacture of high value-added goods. The sort of goods that should be produced must be those that have a demand that rises as people’s incomes rise; this way the producers do not face the sort of problems faced by exporters of primary goods.

It is clear that the way comparative advantage is defined has changed. Whereas it used to be that comparative advantage was considered ‘ God-given’ but new thinking is that it can be created. Furthermore, not all trade patterns can be explained by this old theory and alternative theories and policies must also be considered.

References

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This clearly implies that if two countries have identical resource bases, none will have a comparative advantage in any good and therefore there would be no justification for trade between them.