

Welcome students under the initiative of Directorate of Higher Education, Government of Goa titled Digital integrated system for holistic teaching and virtual orientation for developing content I will be covering module #2 titled Absolute advantage and comparative advantage doctrines.

Here's what we shall cover in this module.

Concept of absolute cost advantage. Illustration of absolute cost advantage limitations of absolute cost theory. Ricardian theory of comparative advantage.

Limitations of Ricardo's theory. Empirical evidence on Ricardo's theory.

On completion of this module.

The learner will be able to describe the gains from trade using the classical trade theories. Explain how the basic Ricardian model of international trade illustrates comparative advantage as the basis of International Trade.

The classical trade theories, both the absolute advantage theory and the comparative advantage theory, provided a strong foundation for the.

Evolution and growth of international trade theory

and the analysis of the gains from trade.

Adam Smith, a classical economics.

Smith is the father of Economics.

Propagated the theory of absolute cost advantage in

his 1776 publication titled an inquiry into the nature

and causes of the wealth of Nations. He explained why

nations trade and what are the gains from trade.

He pointed out that it is the Maxim of every prudent master of

a family never to attempt to make it home. What it will be

costly to make than to buy.

A tailor does not attempt to make his own shoes. He buys it

off the Shoemaker.

A Shoemaker does not attempt to make his own clothes. He employs

the tailor in this manner. Every person engages his entire

industry in a manner that gives him some advantage over his

neighbors and buys whatever he needs with a part of his

produce. This is the basis of Adam Smith's concepts of

division of Labor and Specialization, which results in

gains from international trade to participating nations.

To explain his principles of division of Labor and

Specialization, Adam Smith gave.

An example of making pins.

He observed that in the pinmaking in factory, there are 10 workers performing.

The various task of producing a pin. This. 10 workers produce at Best 20 pins in a day.

He further observed that the 18 processes of making a pin, if subdivided among the ten workers they can produce.

All 10 of them, about 48,000 pins in a day.

Support worker produces 4800 pins in a day that signifies the gains from division of Labor. The efficiency gains from division of Labor and specialization.

When this principle is extended to International Trade, International Trade enhances the scope of international division of Labor and hence it confers gains to the countries who engage in trade.

Let's now look at the meaning of absolute advantage.

Absolute advantage can be defined as the ability of an individual firm or a country to produce more of a good or service than competitors using the same amount of resources.

It can also be stated as the greater efficiency one nation

may have over another in the production of a commodity. For instance, Brazil has the ability to produce more coffee at lesser cost than Japan. Japan can produce more cars than Brazil, so it can be stated that Brazil has an absolute cost advantage in the production of coffee. While Japan has an absolute advantage in the production.

Of course, the law of absolute advantage can be stated.

As follows. Assuming there are two countries mutually beneficial trade between the two countries can take place.

If one of them has an absolute advantage in producing one commodity in terms of lower production costs and the other country has similar absolute advantage in producing some other commodity at a lower production cost.

A Nation is said to have an absolute cost advantage when it uses less units of Labor to produce one unit of a good, than the other nation which uses more units of Labor to produce the same good. Not hear that.

Adam Smith based his theory on the labor theory of value.

Which believe that labor is the only productive input.

The nation will export those goods in which it has an absolute cost advantage and will import those goods in which it

has an absolute cost disadvantage. Look at this table

which illustrates the concept of absolute advantage. There are two countries, country A and Country B and two products, wine and cloth in country A.

A unit of Labor produces 20 barrels of wine.

In country B, the same unit of Labor produces 10 barrels of wine. There is, in terms of

cloth. In country A, the unit of Labor produces 6 bales of cloth and in country B the same amount of Labor produces 18 bales of cloth. It is clear from this example that country A has an absolute advantage in the production of wine.

Country B has an absolute advantage in the production of cloth.

It therefore follows that country A will specialize on the basis of its absolute advantage in the production and export of wine. Country B in cloth.

There will be efficiency gains for both and world welfare will increase. Let's now look at some of the limitations of absolute advantage doctrine. The absolute advantage doctrine requires each nation to be the list cause producer of at least one good.

It ignores the possibility that one nation can be more efficient

than its trading partner in the production of all the goods.

This doctrine can explain only a small part of World Trade, which is based on absolute advantage.

The trade between industrialized countries could not be explained by the doctrine.

Let's now look at an example from a daily life. There is a lawyer who has twice as much speed in typing as a secretary.

The lawyer has an absolute advantage both in the practice of law as well as in typing.

The Secretary has a comparative absolute disadvantage in both.

Yet the lawyer hires the secretary.

This was explained by David Ricardo in his theory of comparative advantage. It is not absolute advantage, but comparative advantage that makes the lawyer hire the secretary.

For instance, if the lawyer owns \$100 in an hour in the practice of law.

And if he spends his time, one hour in typing.

He foregoes \$80.

Let's assume that he pays \$10 for the secretary and his typing speed is twice that of his secretary, so he foregoes \$20 if he spends his time in typing.

Instead, he hires the secretary and then he can concentrate on the practice of law and the secretary, whose absolute advantage is the least in typing will improve his skills overtime.

In 1817 David Ricardo published the principles of political economy and taxation, in which he detailed the theory of comparative advantage. It is comparative advantage according to him, and not absolute advantage, that is the basis of

Inter. National trade

The law of comparative advantage states the following comparative cost differences give rise to trade even if one nation is less efficient than the other nation in the production of both commodities, there's still a basis for mutually beneficial trade.

According to Ricardo, the less efficient nation should specialize in and export the good in which it is relatively less inefficient. In other words, where its absolute disadvantage is the list.

The more efficient nations should specialize in and export the good in which it is relatively more efficient.

That is where its absolute advantage is greatest.

Ricardo's model was a 2 by 2 by

1 model. Which was based on many

simplistic assumptions. He assumed that there are two

countries. Two commodities. Labor is the only productive

factor which is fully employed

and homogeneous. Labour is fully mobile within a nation, but is

not capable of moving between

nations. He assume constant cost of production, that is

cost of product production does not vary with the level

of production, but with the amount of Labor used.

He also assumed that there is prevalence of perfect

competition. There are a large number of buyers and sellers,

and all uh, price takers.

Another assumption is that there is the existence of free trade

and there are no government

barriers to trade. And it is also assumed that the

transportation costs are zero.

Let's look at a numerical illustration of Ricardo's

theory. Let's now look at this example.

Off Ricardo, where he takes two countries, Portugal and England,

and two commodities, wine and cloth. It takes 80 hours of Labor to produce one unit of wine in Portugal, whereas the corresponding cost in England is 120 units of Labor to produce wine. For cloth, Portugal takes 90 units of Labor to produce one unit of cloth, whereas the corresponding figure in England is 100 units of Labor.

It can be seen that Portugal has an absolute advantage in the production of both wine and cloth, while England has an absolute disadvantage in the production of both these commodities.

Ricardo showed that despite this, mutually beneficial trade can take place between these two countries if it is based on comparative advantage. Let's look at column three in the table, which shows the domestic exchange ratio in each country. For Portugal it is  $\frac{80}{90}$  where one wine can be exchanged for 0.88 units of cloth or one cloth will be exchanged for one point, 12 units of wine in England, the domestic exchange ratio is  $\frac{120}{100}$ , where one wine is exchanged for 1.2 units of cloth or one cloth for 0.83 units of wine.

If both these nations decide to trade with each other on the

basis of their comparative cost ratios, it can be seen from the table that Portugal has a lower cost ratio in wine as compared to England and England's disadvantage in cost is the least in cloth. Hence Portugal will decide to specialize in Wine and it will export wine to England, whereas England will specialize in the other commodity that is cloth and will specialize in exporting cloth to Portugal.

We can see that Portugal by importing from England can get more than 0.8 units of cloth for every unit of wine that it exports.

Similarly, England can get with less than 1.2 units of cloth to get a unit of wine from England. So this means that both the countries gain in terms of resources.

The implication from this is that there is mutual gain to both countries when each country exports the good in which it has a competitive advantage.

Each country can then get the imported commodity relatively cheaper than producing on its own. Free trade based on comparative advantage results in most efficient allocation of world resources and maximization of world production.

There are, however, certain limitations to Ricardo's theory.

For example, Ricardo's theory is based on real terms and not money terms. It is based on the labor theory of value and hence inherits the defects of the labor theory of value.

It does not consider increasing or decreasing costs as it assumes constant costs. But in the real world there are increasing or decreasing costs with the scale of production.

There are though, was simplistic. Assumptions of Ricardo's theory, like for example, he assumed that there are no transport costs and there are no government barriers to trade. Whereas in the real world these assumptions do not hold true. Ricardo also does not explain what gives rise to comparative cost differences.

Despite the limitations, there is empirical evidence to support the comparative advantage theory of Ricardo. A study by MacDougall in 1951, where he compared the export patterns of 25 industries for the United Kingdom and USA for the year 1937 found that 20 out of 25 industries fit the predicted pattern. As stated by Ricardo.

A similar study that was repeated by Balassa in 1963 also

supports the ricardian theory.

A more recent study by Stephen Golub in 1995 where he assessed the contemporary relevance of the ricardian model for US trade. Concluded that relative productivity and unit labor cost helped to explain US bilateral trade patterns.

Here's a summary of the main

points. Adam Smith stated that the basis of trade is absolute superiority of 1 nation over another in a particular product.

Whereas David Ricardo emphasized differences in labor productivity, which gives competitive cost advantage to nations in producing particular goods. Both the classical theories highlight the mutual gains from free trade.

The basic prediction of Ricardo that countries will tend to export goods in which they have relatively high productivity has been confirmed by a number of studies.

To conclude, Adam Smith and David Ricardo have left a lasting legacy of their principles of international division of Labor Specialization and gains from free trade.

There have been several refinements and modifications to

the original ricardian theory. However, the opposition to trade restrictions is still largely based on the principle of comparative advantage. The central argument for free trade given by both the economist has stood the test of time.

That's all we have on this module.

Do check the references for further reading.

Thank you.