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**Subject:** Economics  
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**Paper Title:** International Economics  
**Unit No:** 01  
**Title of the Unit:** International Trade  
**Module Name:** Absolute Cost Advantage  
**Module Number:** 01  
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## NOTES

### Outline of the e-module

#### Trade

- i. Meaning of Absolute Cost Advantage.
- ii. Assumptions of Absolute Cost Advantage Theory.
- iii. Advantages of Absolute Cost Advantage.
- iv. Disadvantages of Absolute Cost Advantage.

#### Learning Outcomes

At the end of the session, a student will be able to understand:-

- i. The meaning of Absolute Cost Advantage.
- ii. The assumptions of Absolute Cost Advantage Theory.
- iii. The advantages and disadvantages of Absolute Cost Advantage.

#### Meaning of Absolute Cost

Countries trade with each other when, on their own, they do not have the resources, or capacity to satisfy their own needs and wants. By developing and exploiting their domestic scarce resources, countries can produce a surplus, and trade this for the resources they need.

According to this theory, trade between two countries would be mutually beneficial if one country could produce one commodity at absolute advantage (over the other commodity) and the other countries could, in turn, produce another commodity at an absolute advantage over the first. ...

Absolute advantage is when a producer can produce a good or service in greater quantity for the same cost, or the same quantity at a lower cost, than other producers. Absolute advantage can be

the basis for large gains from trade between producers of different goods with different absolute advantages.

Adam Smith propounded the theory of absolute cost advantage as the basis of foreign trade; under such circumstances an exchange of goods will take place only if each of the two countries can produce one commodity at an absolutely lower production cost than the other country. ...

In economics, the principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce a good or service more efficiently than its competitors. Adam Smith first described the principle of absolute advantage in the context of international trade, using labor as the only input.

The Absolute Advantage Theory theory assumed that only bilateral trade could take place between nations and only in two commodities that are to be exchanged. ... This theory also assumed that free trade exists between nations. It did not take into account the protectionist measures that are adopted by countries.

One real-world example of absolute advantage is in oil production. Nations in the Middle East have an absolute advantage when it comes to producing oil. In oil-rich nations, businesses can use simple, inexpensive techniques to drill for the resource and get it in large quantities

Absolute advantage refers to the ability of a country to produce a good more efficiently than other countries. In other words, a country that has an absolute advantage can produce a good with lower marginal cost (fewer materials, cheaper materials, in less time, with fewer workers, with cheaper workers, etc.).

Absolute advantage is achieved when one producer is able to produce a competitive product using fewer resources, or the same resources in less time. Comparative advantage considers the opportunity cost when assessing the viability of a product, accounting for alternative products.

It is not possible for a country to have a comparative advantage in all goods. However, a country can have an absolute advantage in all goods. An absolute advantage exists when a country is simply the best (most efficient) in producing a product or service.

Absolute advantage – definition and meaning. ... A country with absolute advantage can produce something at lower costs than another. That country requires fewer resources to produce the same number of goods as the other country needs. Panama, a tropical country, can produce bananas much more cheaply than Canada can.

If a nation has an absolute advantage in the production of a good, it can produce that good using fewer resources than its trading partner. If a nation has a comparative advantage in the production of a good, it can produce that good at a lower opportunity cost than its trading partner.

Brazil has an absolute advantage in coffee: – Producing a pound of coffee requires only one labor-hour in Brazil, but two in Argentina.

Absolute advantage and comparative advantage are two concepts in economics and international trade. Absolute advantage refers to the uncontested superiority of a country or business to produce a particular good better.

The Absolute Advantage Theory theory assumed that only bilateral trade could take place between nations and only in two commodities that are to be exchanged. This assumption was significantly challenged when the trade, as well as the needs of nations, started increasing.

### **Theory of Absolute Cost Advantage**

Adam Smith is generally ignored as a trade theorist in text books of international economics because of the common belief that he only confirmed the rule of absolute advantages to explain the structure of foreign trade.

However, his vent-for-surplus approach may be interpreted as a pioneering study which stresses the importance of economies of scale in explaining the structure of trade.

Economists recognize the undeniable influence of Smith’s concepts such as “extent of the market”, “division of labour”, “improved dexterity in every particular workman”, and “simple inventions coming from workman” on trade theory.

Adam Smith propounded the theory of absolute cost advantage as the basis of foreign trade; under such circumstances an exchange of goods will take place only if each of the two countries can produce one commodity at an absolutely lower production cost than the other country.

	<b>Commodity A</b>	<b>Commodity B</b>
<b>Country I</b>	10 labour units	20 labour units
<b>Country II</b>	20 labour units	10 labour units

Suppose, there are two countries I & II and two commodities A and B. For example, country can produce a unit of commodity (A) with 10 and a unit of commodity (B) with 20 labour units, and that in country II, the production of a unit of (A) costs 20 and a unit of (B) 10 labour units. Now country I has absolute cost advantage in the production of (A) and it will confine itself to the production of (A) and country II in the production of (B). Exactly the same would happen if country I and II were two regions of one country. We speak of absolute - differences in costs

because each country can produce one commodity at an absolutely lower cost than the other. Thus, in such a situation, a division of labour between them must lead to an increase in total output.

### **What is Absolute Advantage?**

In economics, absolute advantage refers to the capacity of any economic agent, either an individual or a group, to produce a larger quantity of a product than its competitors. Introduced by Scottish economist, Adam Smith, in his 1776 work, “An Inquiry into the Nature and Causes of the Wealth of Nations,” which described absolute advantage as a certain country’s intrinsic capability to produce more of a commodity than its global competitors.

Smith also used the concept of absolute advantage to explain gains from free trade in the international market. He theorized that countries’ absolute advantages in different commodities would help them gain simultaneously through exports and imports, making the unrestricted international trade even more important in the global economic framework.

### **Adam Smith’s Theory of Absolute Advantage**

The mercantilist economic theory, which was widely followed between the 16<sup>th</sup> and the 18<sup>th</sup> century, came under a lot of criticism with the emergence of economists like John Locke and David Hume. Mercantilism advocated a national economic policy designed to maximize the nation’s trade and its gold and money reserves. Mercantilism gained influence due to the emergence of colonial powers such as Britain and Portugal, before Adam Smith, and later Daniel Ricardo, both staunch critics of the concept, came up with their own theories to counter mercantilism.

Smith was the first economist to bring up the concept of absolute advantage, and his arguments regarding the same supported his theories for a laissez-faire state. In “The Wealth of Nations”, Smith first points out that, through opportunity costs, regulations favoring one industry take away resources from another industry where they might have been more advantageously employed.

Secondly, he applies the opportunity cost principle to individuals in a society, using the particular example of a shoemaker not using the shoes he made himself because that would be a waste of his productive resources. Each individual thus specializes in the production of goods and services in which he or she has some sort of an advantage.

Thirdly, Smith applies the same principles of opportunity costs and specialization to international economic policy, and the principle of international trade. He explains that it is better to import goods from abroad where they can be manufactured more efficiently because this allows the importing country to put its resources into its own most productive and efficient industries. Smith thus emphasizes that a difference in technology between nations is the primary determinant of international trade flows around the globe.

## **Assumptions of the Absolute Advantage Theory**

- Smith assumed that the costs of the commodities were computed by the relative amounts of labor required in their respective production processes.
- He assumed that labor was mobile within a country but immobile between countries.
- He took into consideration a two-country and two-commodity framework for his analysis.
- He implicitly assumed that any trade between the two countries considered would take place if each of the two countries had an absolutely lower cost in the production of one of the commodities.

## **Achieving an Absolute Advantage**

An absolute advantage is achieved through low-cost production. In other words, it refers to an individual, company, or country that can produce at a lower marginal cost. Such an advantage is established when (compared to competitors):

- Fewer materials are used to produce a product
- Cheaper materials (thus a lower cost) are used to produce a product
- Fewer hours are needed to produce a product
- Cheaper workers are (in terms of hourly wage) used to produce a product

## **Absolute Cost Advantage**

Absolute cost advantage results from the specialization of labor proposed by Smith in his theory. Specialization of labor, or division of labor, results in a significantly higher productivity per unit of labor, and in turn, a lower cost of production. Smith also used the concept of “Economies of Scale” to explain the lowering of production costs, as a higher output due to labor diversification would significantly reduce production costs.

## **Criticisms against Absolute Advantage**

The Absolute Advantage Theory theory assumed that only bilateral trade could take place between nations and only in two commodities that are to be exchanged. This assumption was significantly challenged when the trade, as well as the needs of nations, started increasing. Thus, this theory did not take into account the multilateral trade that could take place between countries. This theory also assumed that free trade exists between nations. It did not take into account the protectionist measures that are adopted by countries. These protectionist measures included quantitative restrictions, technical barriers to trade, and restrictions on trade on account of environmental protection or public policy.

1. No absolute advantages for many countries.
2. Country size varies.

3. Country by country differences in specializations.
4. Deals with labour only and neglects other factors of production .
5. Neglected Transport cost .
6. Theory is based on an assumption that Exchange rates are stable and fixed.
7. It also assumes that labor can switch between products easily and they will work with same efficiency which in reality cannot happen.

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