

Welcome students.

My presentation is on Absolute advantage theory.

Course title is international Economics semester 6.

Bachelor of Commerce.

The title of the Unit is International Trade.

Absolute Advantage theory

module #2.

The outline of this presentation.

In this presentation, I will be discussing the meaning

of absolute cost advantage.

The assumptions of absolute

cost advantage theory.

The Merits or advantages of

the absolute cost theory and

the disadvantages of the theory.

Learning outcomes at the end of the session,

the student will be able to

understand the meaning of

absolute cost advantage.

The assumptions of the theory,

the advantages and

disadvantages of the theory.

The 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.

Absolute cost theory.

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 country could in

turn produce another commodity at

an absolute advantage over the 1st country

The theory of absolute cost advantage.

Adam Smith propounded the theory

of absolute cost advantage as

the basis for 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 this example,
we can see that country 1 can
produce commodity A using 10 labor units.
And commodity B using 20 labor units.

So in this example we can see that
country 1 can produce commodity
A at an absolute advantage.

Country 1 has got absolute
advantage or absolute cost advantage
in the production of commodity A because it has to use less
labor units than commodity B.

In the same way Country 2.
Uses 20 labor units to produce
commodity A and it uses 10 labor
units to produce commodity B.

So here we can see Country 2.
Has absolute cost advantage in

the production of commodity B

because it is using 10 labor units,

then the other commodity

where it has to use 20 laborers.

Now what is going to happen in trade?

In the trade.

Country One is going to produce

commodity A because it has got absolute

cost advantage in the production of

commodity A and Country 2 is going

to produce commodity B because it

has got absolute cost advantage

in the production of commodity B.

This is what the theory is all about.

Now let us see what are the assumptions

to the absolute advantage theory.

Adam Smith assumed that the costs of

the commodities are computed by the

relative amount of Labor required in

their respective production processes.

So here we see that the cost of

production is measured in terms of Labor units and not in terms of currencies.

Second assumption, he assumed that labor was mobile within the country, but immobile between countries.

Assuming that if Labour wants to move from one country to another,

there are a lot of formalities,

he needs visa, he needs permission.

He also needs like if he wants to export goods some permissions are required, so these were some of the problems

that were there in the theory.

The third assumption that he assumed

was he took into consideration

a two country and two commodity

framework for his analysis.

The 4th assumption that he made was

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.

The advantages of the

absolute advantage theory.

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 fewer

materials were used to produce a product.

Cheaper materials are used to produce

a product, thus lowering the cost.

Fewer hours are needed to produce a product.

Cheaper workers are used

to produce a product.

Absolute cost advantage results

from the specialization of Labor

proposed by Adam Smith in his theory.

Specialization of Labor or division of

Labor results in a significantly higher

productivity per unit of Labor and

in turn lower cost of production.

Adam Smith also used the concept

of economies of scale to explain

the lowering of production costs.

As a higher output due to division of labor

would significantly

reduce production costs.

The criticisms of the absolute

advantage theory.

The first criticism is there is no

absolute advantages for many countries.

The second criticism is country size varies.

We know that there are big

countries and that there are small countries,

so we do not know which country,

whether it's a big country

or a small country,

which country will have absolute advantage.

So that's the reason why there's no

absolute advantage for many countries.

Country by country differences in specialization.

Now here what happens?

Each country has got specialization

in something or the other,

so we cannot generalize.

The 4th criticism is.

It deals with labor only and neglects

other factors of production.

Now we have four factors of production,

land, labor, capital and enterprise.

Now this theory neglects the other three.

And it tries to measure the cost

of production in labor units only.

It does not check how much land,

how much capital and how

much enterprise is required.

The 5th criticism is it

neglects the transport cost.

The theory, is based on an assumption that

exchange rates are stable and fixed,

which might not be true as we

all know exchange rates go on

fluctuating day by day.

The theory also assumes that labor
can switch between products easily and
they will work with same efficiency,
which in reality cannot happen.

These are my references.

Thank you.