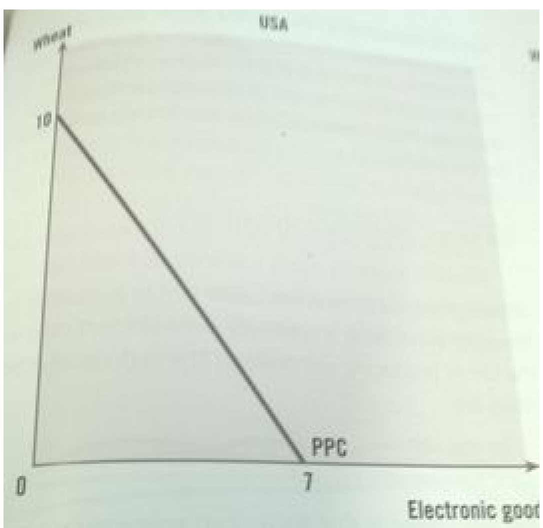
Globalisation and International Trade

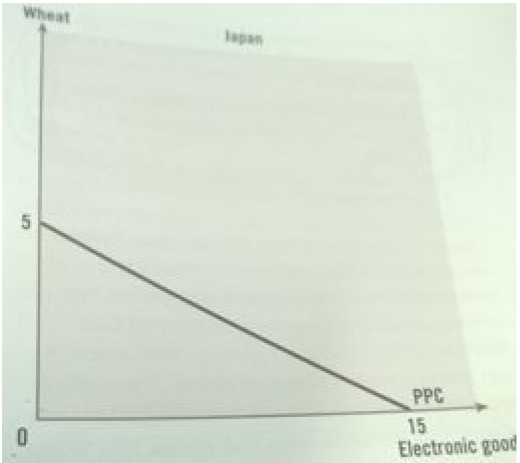
Absolute and Comparative Advantage

To understand the economics of trade, you must be able to understand specialisation. Countries specialise in things they can produce efficiently, for example in Latin America they produce bananas more efficiently than we do in the UK. By exporting these goods, the country can earn revenue to import the goods they can produce less efficiently.

The goods and services that countries should specialise in are determined by their absolute and comparative advantages.

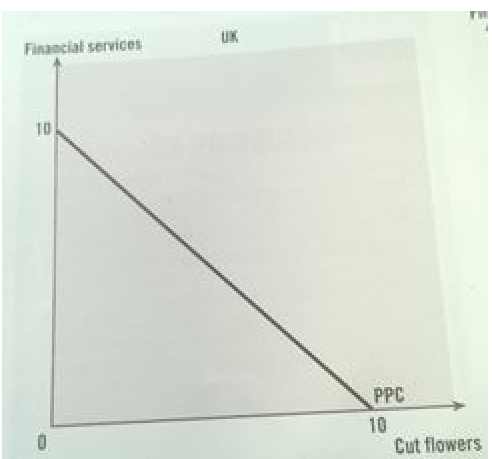
A country has an **absolute advantage** when they **are able to produce more of a good or service with the same amount of resources than another country, meaning that the unit cost of production is lower.** We can show AA by using PPC's:

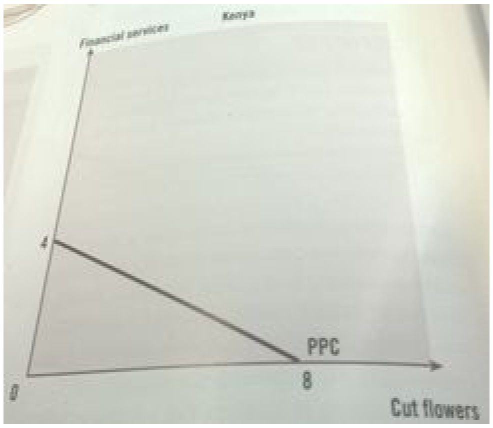




In the diagrams above, there is a clear basis for trade – each country's absolute advantage complements the others. This is known as **reciprocal absolute advantage**.

But what happens if one country doesn't have an AA in the production of any good? Does that mean there is no basis for trade? Ricardo said that there is still a basis for trade, because cost can be thought of as a relative concept as well as an absolute one. There is an opportunity cost to resource use. **Comparative advantage** is when **one country produces a good or service at a lower relative opportunity cost than others.** This can be shown below:





The UK has an AA in producing both flowers and financial services. Why would they trade with Kenya? For the UK, the opportunity cost of producing one unit of financial services is one unit of flowers. The OC ratio is:

1 financial services: 1 flowers

For Kenya, the OC ratio is:

1 financial services: 2 flowers

Although Kenya is relatively inefficient at producing financial services, it is relatively more efficient than the UK in producing flowers. The OC ratios are:

For the UK – 1 flowers: 1 financial services

For Kenya – 1 flowers: 0.5 financial services

This means that Kenya can produce cut flowers with a smaller sacrifice in the production of financial services than it is possible in the UK. When a country has a lower relative opportunity cost of production in one good or service than another, it is said to have a comparative advantage. There is a basis for trade, as the UK would make better use of its scarce resources if it specialised in producing financial services and traded these with Kenya for flowers. The two countries would then have to agree **terms of trade**. The UK would need to be able to buy more than one flower for every financial service it exports, or it may as well produce flowers themselves. Kenya would not want to sell more than two flowers to buy one service, as it can produce services itself at this cost.

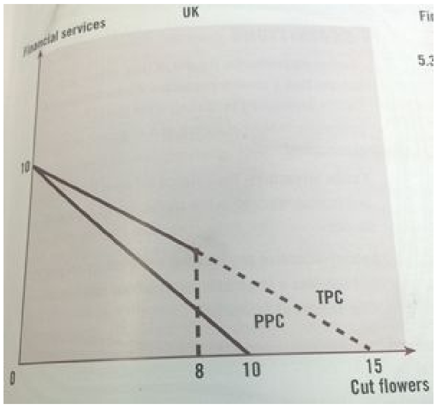
Terms of trade are the price of a country's exports relative to the price of its imports. They can be measured using the formula:

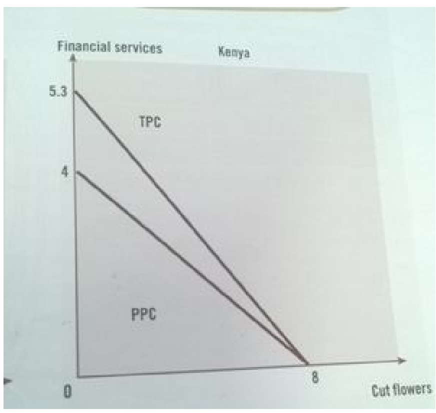
(Index of average export prices/index of average import prices) x100

The terms of trade tell you the volume of exports needed to purchase any given volume of imports. A rise in the terms of trade is seen as an **improvement** in terms, as it means that a lower amount of exports are needed to buy imports. If the opposite happens, the terms of trade have **deteriorated**. In the long term, the terms of trade for primary commodities e.g. coffee have deteriorated, and this means that there can be problems for developing countries, as these often rely on producing primary commodities, and each country is so small in terms of exports that they aren't able to influence world prices. The **Prebisch-Singer Hypothesis** says that, because of this, developing countries should switch towards producing secondary sector or capital goods.

Even an improvement in the terms of trade may not always be a good thing, as it could be due to reduced international competitiveness. Also, the terms of trade don't tell you how much the volume of imports and exports is. Rising export prices give the opportunity for economies to gain for trade, but much will depend on the PED for the goods. Where the PED is elastic, there could be a fall in the value of exports if prices rise. This could affect the current account of the BOP and AD negatively. A deterioration in the terms of trade will not necessarily make the economy worse off, as long as the volume of trade is increasing sufficiently.

Imagine that the terms of trade are 1 financial service for 1.5 flowers. At this price, the UK could buy 15 flowers if they produced services and sold them all to Kenya. Kenya could buy 5.3 services (8/1.5) if they produced flowers and sold them all to the UK. Notice that this means that each country could consume outside its PPC. The consumption possibilities possible through trade are shown by each country's **trading possibility curve** (TPC) as shown below:





Even if one country has an AA in the production of all goods and services, another country will have a CA in something and trade will benefit both.

The sources of CA will depend on the resources that each country has. The **factor endowments** of a country are the mix of land, labour and capital that the country has. Different goods have different **factor intensities** – some goods are labour intensive and some are capital intensive. A country like China which has cheap labour will have a CA in producing goods which are labour intensive. The **Heckscher – Ohlin theory of international trade** says that a country will export products producing factors of production that are abundant and import products whose production requires the use of scarce resources. A country's CA will change over time. As GDP rises, higher level of saving will mean that more capital is accumulated, and more spending on education will raise the skill level of the workforce.

Specialisation leads to an overall rise in global output, although the effects on individual countries will depend on the terms of trade. There are also dangers with specialisation – e.g. if resources run out, or demand for the good produced falls, or if another country becomes more efficient at production.

Question:

Analyse why the theories of absolute advantage and comparative advantage provide a basis for trade (12)