Theories of International trade

Absolute Advantage Theory of Adam Smith:-

• A nation has absolute advantage over another nation if it can produce a commodity more efficiently.

• When one nation has absolute advantage in production of a commodity, but an absolute disadvantage with respect to the other nation in a second commodity, both nations can gain by specializing in their absolute advantage good and exchanging part of the output for the commodity of its absolute disadvantage.

• Example:

Canada is efficient in growing wheat, inefficient in growing bananas.

○ Nicaragua is efficient in growing bananas, inefficient in growing wheat.

○ Canada has absolute advantage in wheat; Nicaragua has absolute advantage in bananas.

○Mutually beneficial trade can take place if both countries specialize in their absolute advantage.

• Specialization and trade advantage both countries.

• Adam Smith and other classical economists advocated policy of laissez-faire, or minimal government interference with economic activity.

• Free trade would cause world resources to be utilized most efficiently, maximizing world welfare.

Comparative Advantage Theory of David Ricardo:-

Even if one nation is less efficient than (has absolute disadvantage with respect to) the other nation in production of both commodities, there is still a basis for mutually beneficial trade.

Note that in 2 nation, 2 commodity world once it is determined that one nation has a comparative advantage in one commodity then the other nation must necessarily have a comparative advantage in other commodity.

○ **Case of no comparative advantage -** If one nation has **absolute** disadvantage in both the commodities **in the same proportion for both commodities.** If this proportion is different then also trade is possible

○ Comparative Advantage and Opportunity Costs

We can use the opportunity cost theory to explain comparative advantage:

○ The opportunity cost of a commodity is the amount of a second commodity that must be given up to release just enough resources to produce one additional unit of the first commodity.

 Nation with the lower opportunity cost in the production of commodity has a comparative advantage in that commodity

 (The original idea of comparative advantage was based on the **labor theory of value** given by Adam Smith

○ The value or price of a commodity depends exclusively on the amount of labor used to produce it.

 It implies

1) That either L is the only factor of production or labor is used in same fixed proportion in production of all commodities

2) And that labor is homogeneous.

Since neither of assumption is true we cannot base explanation of comparative advantage on labor theory of value).

 Thus we conclude that difference between the relative commodity prices between the two nations (given by the difference between their PPC or transformation curve) is a reflection of their comparative advantage & provides basis for trade. (Trade continues till relative commodity prices become equal)

○ Production Possibilities Frontier

A curve that shows alternative combinations of the two commodities a nation can produce by fully using all resources with best available technology.

○ When PPC is a straight line it shows that their opportunity costs are constant (not necessarily equal) (Constant costs are not realistic)

○ Slope of the PPC is called marginal rate of transformation

○ Production frontiers differ because of different factor endowments and/or technology in different nations.

○ Constant opportunity costs arise when:

i. Resources are either perfect substitutes for each other or used in fixed proportion in production of both commodities, and
ii. All units of the same factor are homogeneous.

The Basis for and the Gains from Trade under Constant Costs

• In the absence of trade, a nation's production possibilities frontier also represents its consumption frontier.

• Increased output resulting from specialization and trade represents nations' gains from trade, allowing nations to consume outside production possibilities frontier.

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