International trade

Principles/Theories of international trade.

Otong Alex, +256759336820

The principle of absolute advantage

- ✓This principle states that "given two countries and two commodities with a given amount of resources one country can produce both commodities more cheaply than the other."
- ✓The theory states that given two countries producing two commodities using similar resources, a country should specialize in the production of the commodity where it can produce more units at lower costs than the other country.

Example

Country	Resources	Cloth('000 meters)	Beans('000 tones)
A	1,000	10	40
B	1,000	08	20

Assumptions of the principle of Absolute Advantage

- ✓There are only two countries in the world(Bilateral trade).
- ✓There are only two commodities produced in the two countries.
- ✓There are same amount of resources in the two countries.
- ✓Labour is the only factor of production.
- ✓Labour is mobile within the country but immobile between countries.

The principle of comparative cost advantage

- This principle" states that a country should specialize in the production of a commodity in which it has least/lowest opportunity cost in comparison with another country"
- "Comparative advantage exists when given two commodities and two countries with a given amount of resources one country can produce one commodity more cheaply than the other"

Example of comparative advantage:

Country	Resources	Cloth ('000 meters)	Rice ('000 tons)
A	1000	10	40
B	1000	8	20

Opportunity cost

NB; $opportunity\ cost = \frac{alternative\ foregone}{Actual\ output}$

- Country A

✓ Clothes

$$\frac{40}{10} = 4\ tonnes\ of\ rice$$

✓ Rice

$$\frac{10}{40} = 0.25\ meters\ of\ cloth$$

✓ Therefore, country A should produce Rice

- Country B

✓ Clothes

$$\frac{20}{8} = 2.5\ tonnes\ of\ rice$$

✓ Rice

$$\frac{8}{20} = 0.4\ meters\ of\ cloth$$

✓ Therefore country B should produce cloth

Assumptions of the principle of comparative advantage

- ✓ There are only two countries e.g. country A and country B.
- ✓ Only two commodities are produced e.g. commodity rice and cloth
- ✓ No transport costs are incurred in transferring the goods between the two countries.
- ✓ There is free trade between the two countries i.e. there are no trade barriers between the two countries.
- ✓ There is full employment of resources/ factors of production in both countries.
- ✓ Technology is constant.
- ✓ Factors of production are perfectly mobile within each country.
- ✓ Trade between the two countries is on the basis of barter trade system.
- ✓ Homogeneity of factors of production is assumed for example all units of labour homogeneous or equally skilled.
- ✓ Tastes and preferences are similar in both countries.

RELEVANCE/APPLICABILITY OF THE PRINCIPLE OF COMPARATIVE ADVANTAGE

Note: To a lesser extent, the principle is applicable in developing countries and the following reasons are given to support that.

- ✓Developing countries have tended to specialize in agricultural production where they have least/lowest comparative cost
- ✓There are some barter trade arrangements in developing countries as assumed by the theory because of lack of adequate foreign exchange.
- ✓There is some degree of mobility of factors of production within individual countries as assumed by the theory
- ✓Developing countries mostly import manufactured goods where they have less comparative advantage.
- ✓There are some cases of free trade as assumed by the theory as a result of economic integration e.g. preferential trade area etc.
- ✓There is use of labour intensive techniques of production which is abundant and cheap for developing countries. This is because there is surplus labour

Irrelevance/inapplicability/limitations/criticism of the principle of comparative advantage

NOTE: The weakness of comparative advantage theory is that it is based on a number of assumptions that are not realistic.

- ✓ It wrongly assumes only two countries involved in international trade. The reality is that world trade is multi-lateral involving many countries.
- ✓ The assumption of only two commodities is unrealistic. There are more than two commodities produced in the two countries depending on demand for goods and service hence there is production of a wide variety of commodities.
- ✓ It assumes barter trade as the only means of exchange which is wrong. But in reality in modern economies there is monetary exchange and barter trade is continuously dying out.
- ✓ It assumes free trade yet in reality there are trade barriers. This is because trade is often subjected to barriers to discourage imports and exports which limit the volume of trade operations.
- ✓ It does not consider possibility of changes in technology yet there is technological progress. Technological changes bring about changes in productive efficiency which helps to reduce costs of production of goods and increase their supply.
- ✓ It ignores transport costs which cause differences in costs of production and this is not true. This is because transport costs determine the pattern and profitability in international trade in developing countries.
- ✓ It wrongly assumes the possibility of full employment. In developing countries, there is underutilization of resources which is reflected in excess capacity in production units due to low levels of technology, limited market, etc.

Continuation

- ✓ It ignores the possibility of international mobility of factors of production. There can be international mobility of factors of production but also factors of production are not perfectly mobile within a country as the theory assumes.
- ✓ It assumes homogeneity of factors of production yet they are not equally efficient. This is because different units of factors of production possess different level of productivity and therefore they are different therefore not homogeneous. e.g. skilled ,semi skilled, and unskilled labour.
- ✓ It assumes that demand is elastic yet the demand for agricultural products is inelastic. Hence LDCs don't benefit in international trade due to low prices offered.
- ✓ It ignores the possibility of absolute cost advantage. It is possible for a country to produce both commodities more cheaply than the other which makes it difficult to determine the commodity in which either country should specialize.
- ✓ It ignores possibility of change in comparative advantage over time yet it can change. It may change in favour or dis-favour of one commodity over the other overtime. e.g. a country may be good in production of a commodity but because of improvement in technology, it shifts to production of another instead overtime.
- ✓ It ignores the need for self reliance by countries. Countries try to avoid over specialisation and try to produce a wide variety of goods as much as possible to reduce reliance on other countries.

Continuation

- ✓ It ignores the existence of diminishing returns yet diminishing returns occur. Most developing countries are agro based economies and diminishing returns occur which reduces productivity or the level of output of the commodity where the country has a comparative advantage may reduce.
- ✓ It makes poor countries poorer/poor terms of trade. Developing countries specialise in the production of primary products whose prices are always lower and ever falling compared to manufactured goods from MDCs, hence the theory perpetually commits developing countries to being poorer as producers of primary products leading to unfavourable terms of trade.
- ✓ It ignores the existence of different currencies used. Yet currency differences between and among countries exist which affects costs of production.
- ✓ There are no constant costs as assumed by the theory. There are economies and diseconomies of scale due to specialization in one commodity and this leads to varying average costs of production yet its ignored by the theory.
- ✓ It assumes similar needs (tastes and preference) in the two countries which is not true. This is because different countries have different needs depending on age, religion, sex/gender, etc hence production of different goods and services.
- ✓ It ignores equal costs of production/identical opportunity costs. Countries may have the same costs in the production of a certain commodity and it becomes hard to find which country should specialise in a particular commodity.