International Economics

Lecture Note 2

Absolute Advantage and Comparative Advantage

Absolute Advantage

In the 1700s, famous economist Adam Smith taught us that countries should find out what they can produce more efficiently (which really means cheaper, better and faster), and then specialize in what they do best while trading with other countries who are also doing what they're best at.

For example, let's say you're entering the job market and you're evaluating your options for a career. At the same time, your neighbor, Bob, is also evaluating his options. Now, you have an absolute advantage over Bob in baking cakes. Whether it's chocolate cake, vanilla cake or pineapple-upside-down cake, if both of you baked the same cakes side-by-side, you'd be the one who could bake three times as many cakes in an hour as he could. You're really good at baking cakes, and certainly better than Bob is (who's struggling to get the first cake rolling). Between the two of you, you are the best at it. In economics, we say you have an **absolute advantage** over your neighbor *when you can produce a good more efficiently in the same amount of time.*

Comparative Advantage

Comparative advantage is when a country produces a good or service for a lower opportunity cost than other countries. Opportunity cost measures a trade-off. A nation with a comparative advantage makes the trade-off worth it. The benefits of buying its good or service outweigh the disadvantages. The country may not be the best at producing something. But the good or service has a low opportunity cost for other countries to import.

For example, oil-producing nations have a comparative advantage in chemicals. Their locally-produced oil provides a cheap source of material for the chemicals when compared to countries without it. A lot of the raw ingredients are produced in the oil distillery process. As a result, Saudi Arabia, Kuwait, and Mexico are competitive with U.S. chemical production firms. Their chemicals are inexpensive, making their opportunity cost low.

In the past, comparative advantages occurred more in goods and rarely in services. That's because products are easier to export. But telecommunication technology like the internet is making services easier to export. Those services include call centers, banking, and entertainment.

Theory of Comparative Advantage

Eighteenth-century economist David Ricardo created the theory of comparative advantage. He argued that a country boosts its economic growth the most by focusing on the industry in which it has the most substantial comparative advantage.

For example, England was able to manufacture cheap cloth. Portugal had the right conditions to make cheap wine. Ricardo predicted that England would stop making wine and Portugal stop making cloth. He was right. England made more money by trading its cloth for Portugal's wine, and vice versa. It would have cost England a lot to make all the wine it needed because it lacked the climate. Portugal didn't have the manufacturing ability to make cheap cloth. So, they both benefited by trading what they produced the most efficiently.

Ricardo developed his approach to combat trade restrictions on imported wheat in England. He argued that it made no sense to restrict low-cost and high-quality wheat from countries with the right climate and soil conditions. England would receive more value by exporting products that required skilled labor and machinery. It could acquire more wheat in trade than it could grow on its own.

The theory of comparative advantage explains why trade protectionism doesn't work in the long run. Political leaders are always under pressure from their local constituents to protect jobs from international competition by raising tariffs. But that’s only a temporary fix. In the long run, it hurts the nation's competitiveness. It allows the country to waste resources on unsuccessful industries. It also forces consumers to pay higher prices to buy domestic goods.

David Ricardo started out as a successful stockbroker, making $100 million in today's dollars. After reading Adam Smith’s "The Wealth of Nations," he became an economist. He pointed out that significant increases in the money supply created inflation in England in 1809. This theory is known as monetarism.

He also developed the law of diminishing marginal returns. That’s one of the essential concepts in microeconomics. It states that there is a point in production where the increased output is no longer worth the additional input in raw materials.