

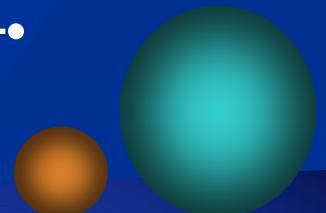
# *International Trade Theory*

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# Introduction

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- ❖ International Trade is concerned with the exchange of capital, goods, and services across international borders or territories.
- ❖ Knowledge of international trade is necessary to understand what goes in the world of today and to be informed consumers.



# The Mercantilists' Views on Trade

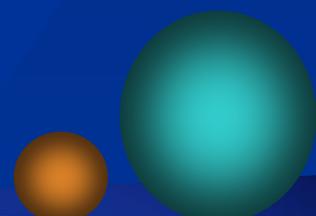
- ❖ Thomas Munn (1571-1641): the mercantilists supported that the way for a nation to become rich and powerful was to export more than it imported.
- ❖ The resulting includes the inflow of bullion, or precious metals, primarily gold and silver
- ❖ Therefore, one nation could gain in the expense of other nations

# The Mercantilists' Views on Trade

- ❖ However: today we measure the wealth of nation by stock of human, man-made and natural resources available for producing goods and services
- ❖ → The greater the stock of useful resources, the greater is the flow of goods and services to satisfy human wants and the higher the standard of living in the nation

# Trade Based on Absolute Advantage: Adam Smith

- ❖ A country enjoys an **absolute advantage** over another country in the production of a product if it uses fewer resources to produce that product than the other country does.
- ❖ ASSUME: **Labor** is the only resource of production



# Absolute Advantage

## LABOR USED FOR RICE AND COTTON PER TON

	Country A	Country B
Rice	20	40
Cotton	80	20

- Country A can produce with two times less of production cost for rice than Country B can, and Country B uses four times fewer labor for producing cotton. We say that the two countries have *absolute advantage*.

# Absolute Advantage

- Suppose that each country has 800 units of factor of production and divides its land to obtain equal units (400 units for each) of cotton and rice production.

**TOTAL PRODUCTION OF RICE AND COTTON ASSUMING NO TRADE,  
MUTUAL ABSOLUTE ADVANTAGE, AND 400 AVAILABLE UNITS**

	Country A	Country B	<b>TOTAL</b>
Rice	20 (400 units/20)	10 (400 units/40)	30 Tons
Cotton	5 (400 units/80)	20 (400 units/20)	25 Tons

# Gains from Specialization

- ❖ If both countries agree to produce only the commodity that each specializes in, Country A uses 400 units of labor for only rice while Country B produces only cotton. Suppose each country exports 12 units of commodity to the other.

## PRODUCTION AND CONSUMPTION AFTER SPECIALIZATION

	PRODUCTION		CONSUMPTION	
	Country A	Country B	Country A	Country B
Rice	40 (800 units/20)	0	28 (40-12)	12
Cotton	0	40 (800 units/20)	12	28 (40-12)

# Gains from Specialization

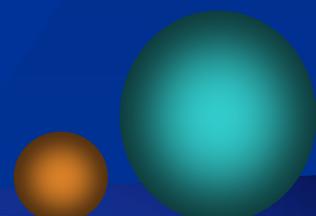
## CONSUMPTION INCREASED FROM INTER. TRADE

	Country A	Country B
Rice	8 (28-20)	2 (12-10)
Cotton	7 (12-5)	8 (40-20)

- Both Country A and Country B can increase their consumption of rice and cotton when they choose to produce and export the commodity they specializes in and import the commodity they have ***absolute disadvantage***.

# Gains from Specialization

- ❖ Both countries can gain by each specializing in the production of the commodity of its absolute advantage and exchanging part of its output with the other country for the commodity of its absolute disadvantage



# Trade Based on Comparative Advantage: David Ricardo

- ❖ **Law of Comparative Advantage:** even if one country is less efficient than (has absolute disadvantage with respect to) the other country in production of both commodities, gain from trade is still possible.
- ❖ The country with absolute disadvantage in both commodities should specialize in the commodity in which its **absolute advantage is smaller.**

# Comparative Advantage

## LABOR USED FOR RICE AND COTTON PER TON

	Country A	Country B
Rice	40	25
Cotton	80	20

- Country B produces both commodities with fewer labor. It means that Country B has absolute advantage for both commodities.
- Therefore, how international trade take places?

# Comparative Advantage

- Suppose that each country has 800 units of factor of production and divides its land to obtain equal units (400 units for each) of cotton and rice production.

**TOTAL PRODUCTION OF RICE AND COTTON ASSUMING NO TRADE,  
MUTUAL ABSOLUTE ADVANTAGE, AND 400 AVAILABLE UNITS**

	Country A	Country B	<b>TOTAL</b>
Rice	10 (400 units/40)	16 (400 units/25)	26 Tons
Cotton	5 (400 units/80)	20 (400 units/20)	25 Tons

# Gains from Comparative Advantage

- ❖ If both countries agree to produce the commodity they have comparative advantage, Country A uses 400 units of labor for only rice while Country B applies 600 units for cotton and 200 units for rice. Suppose Country A exports 9 units of rice while Country B exports cotton.

## PRODUCTION AND CONSUMPTION ACCORDING TO THE LAW OF COMPARATIVE ADVANTAGE

	PRODUCTION		CONSUMPTION	
	Country A	Country B	Country A	Country B
Rice	20 (800 units/40)	8 (200 units/25)	11 (20-9)	17 (8+9)
Cotton	0	30 (600 units/20)	9	21 (30-9)

# Gains from Specialization

## CONSUMPTION INCREASED FROM INTER. TRADE

	Country A	Country B
Rice	1 (11-10)	1 (17-16)
Cotton	4 (9-5)	1 (21-20)

- Even Country A has absolute disadvantage in both commodities, the country can specializes in production and export the commodity in which its absolute advantage is less (rice).

# Conclusion

- ❖ The mercantilists believed that a country could gain in international trade only at the expense of other nations. Therefore: they advocated restrictions on imports, incentives for exports and strict government regulation of all economic activities.
- ❖ When each country specializes in the production of the commodity of its absolute advantage and exchange part of its output for the commodity of its absolute disadvantage

# Conclusion

- ❖ Even if one country is less efficient than the other in the production of both commodities, there is still a basis for mutually beneficial trade. The less efficient country should specialize in the production and export of the commodity in which its absolute advantage is less.
- ❖ Researchers found that comparative advantages seemed to be based on differences in **labor productivity** or costs, as postulated by Ricardo.