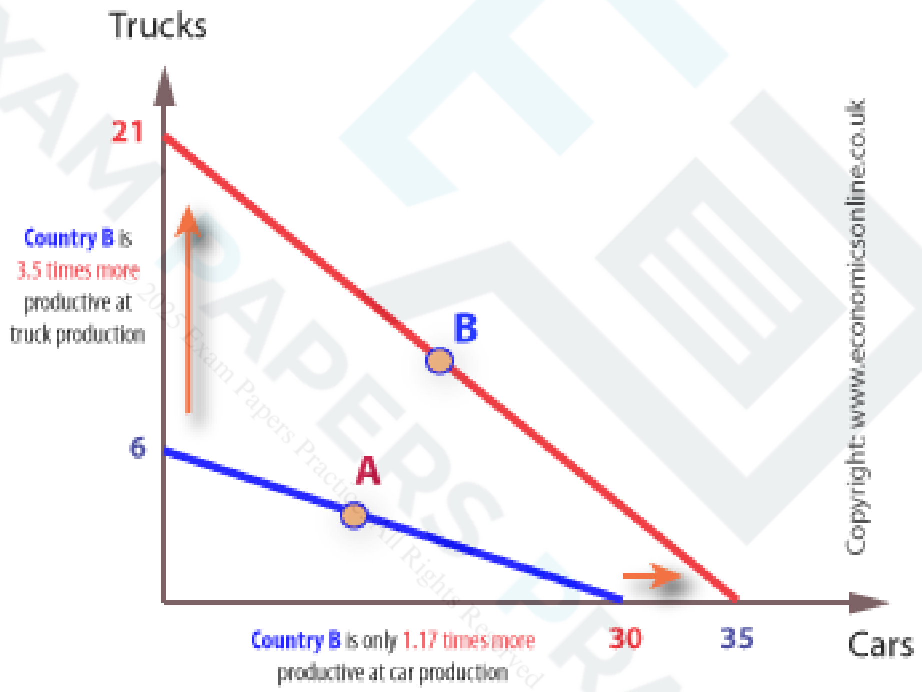
4.1.2 Specialisation and trade

a) Absolute and comparative advantage (numerical and diagrammatic): assumptions and limitations relating to the theory of comparative advantage
b) Advantages and disadvantages of specialisation and trade in an international context

- Absolute advantage: a country can produce more of one product that another country can with the same amount of resources
- When a country has an absolute advantage it is clear they could benefit by specialising in the product which it has an absolute advantage
- Comparative advantage: a country can produce a good with a lower opportunity cost than that of another country



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- Country B has an absolute advantage in both goods but Country A has a comparative advantage in cars
- David Ricardo demonstrated that trade between the two nations can be beneficial to both if each specialises in the production of a good in which it has a comparative advantage (even if one has an absolute advantage in both products). The crucial requirement is a difference in the opportunity cost of producing the products
- Countries can't produce all the things they want or need because resources are unevenly distributed
- Gains from trade:
  - Static gains: improvements in allocative and productive efficiency
  - Dynamic gains: the gains from improved product quality, increased choice and faster and more innovative behaviour
- Factor endowment effect:

    - We specialise in the sectors where we have the resources which affects our opportunity cost
- For trade both countries must benefit so neither country will pay more for a good than it would cost to produce it themselves, and neither will accept less for a good than it costs for them to produce
- The assumptions of the law of comparative advantage:
    - Constant returns to scale implying the PPFs are drawn as straight lines
    - Oversimplified- two products/ two countries
    - No transport costs
    - No diseconomies of scale
    - No trade barriers
    - Perfect knowledge
    - Perfect mobility of factors
    - Externalities are ignored
- For the trade to be beneficial the terms of trade must lie between the opportunity cost ratio
- Terms of trade: it measures the price of a country's exports relative to the price of its imports.
- Terms of trade index: (average price of exports/average price of imports) x 100
- Limitations of the law of comparative advantage;
    - Free trade is not necessarily fair trade (rich countries may exert their monopsony power to force poor countries to accept low prices
    - It is based on unrealistic assumptions
    - If opportunity costs were the same there would be no benefit
- Advantages of specialisation and trade:
    - Higher living standards and increased employment resulting from an increase in world output
    - Export revenues
    - Increased competition
    - Better access to technology
    - Inflow of knowledge
    - Lower prices, increased choice
    - The world's resources are used more efficiently
    - Transfer of management expertise and technology transfer
    - Exploiting economies of scale
    - Reduction in the power of domestic monopolies
- Disadvantages of specialisation and trade:
    - A deficit on the trade in goods and services balance if a country's goods and services are uncompetitive
    - Danger of dumping- it can cause local producers to go bankrupt and in the long-run the country could become dependent on imports
    - Increased unemployment
    - Increased risk of contagion and disruption resulting from problems in the global economy
    - Unbalanced development: international specialisation based on free trade means only industries which the country has a comparative advantage in will be developed which could cause sectoral imbalance, which could limit economic growth
    - Negative externalities

  - Structural unemployment
  - Rising inequality
  - Vulnerable to external shocks
  - Overreliance on one industry
  - TNCs may become global monopolies
  - Foreign competition may force domestic industries to close down
  - Currency exchanges, higher transport costs and legal requirements can cause financial losses
- Sectoral imbalance: an imbalance in the three main sectors of the economy- primary, secondary and tertiary
- Dumping: when a country has a surplus so sells a product abroad for less than it cost to produce. Under the WTO, it is illegal
- Reasons why developing countries may face problems from specialisation:
  - Infant industries may be unable to compete and go out of business
  - Monopsony power of firms in developed economies might force producers in developing countries to accept low prices for their products
  - Declining terms of trade for countries dependent on primary products

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